Searcy
Estate & Gift Tax
Fall 1997

INSTRUCTIONS

You have three hours to complete your answers to this exam. Because the subparts vary in difficulty and complexity, the point allocation among subparts varies. The point allocation is not being announced -- part of your job is to determine which questions are relatively easy and deserve little time and which are more difficult or complex and deserve more time.

"Analyze" means verbally explain the result and rationale, with ~L~LBL~S~ citation to appropriate authority (Code, regulation, case, ruling, or a combination thereof). It is always necessary to apply the relevant facts to the law. There are a few situations in which the regulations provide the best authority; regulation citations are expected in such instances, but do not spend too much time seeking those cites. Use any understandable abbreviations that you wish. If resolution of an issue turns on a few Code or reg. words, quote the words and explain the proper interpretation thereof. Because of the rather large number of subparts on this exam, answers must be brief and concise. Answer only the precise question asked.

If math errors are made, they will not count off at all, provided your answer shows that you knew how to solve the problem and selected the appropriate numbers to begin with. Of course, if you select the wrong numbers to begin with [e.g., by using FMV at date of death when the correct solution calls for using FMV at date of gift] your answer will be graded as wrong in that regard. "Roughing in" numerical answers and other mathematical shortcuts is entirely acceptable.

Unless instructed otherwise, assume that all previously stated facts and legal results remain in full effect in ~U subsequent subparts of the same problem. Answer subsequent subparts consistent with your prior answers unless instructed otherwise. Do not repeat your explanation in a prior subpart of the same problem, but refer back to your prior explanation whenever appropriate.

"Assume" means accept the correctness of the statement or the new fact without discussion and without Dreiudice to the correctness of any of your answers to previous subparts. In multi-part problems, all assumptions remain fully in effect for all subsequent subparts unless instructed to the contrary.

All parties are unmarried adults, fully competent, unrelated to one another, not under one-another's control, and having no obligation (support or otherwise) to one another unless indicated otherwise. All transfers are for no consideration in money or money's worth unless indicated otherwise. All parties are in a common law state and have no community property.

Answer all questions by reference to the statutory provisions disregarding the Taxpayer Relief Act of 1997 changes.

Assume that sec. 2032 Alternate Valuation and sec. 2032A Special Use Valuation are altogether inapplicable. Disregard state taxes altogether (e.g., secs. 2011, 2012, 2015 and 2603). Assume all transfers are irrevocable unless stated otherwise. Disregard apportionment of death taxes, gift taxes, income taxes, and administrative expenses among beneficiaries and other parties. Disregard the GSTT altogether. Unless instructed to the contrary, disregard the sec. 2503 PDE, the election by which a husband and wife may "split" their gifts, and the method by which actuarial factors have been
determined.

Each student may bring into the exam:

1. The Internal Revenue Code of 1986 and Regulations, with page tabs.

2. One sheet of paper 8-1/2 x 11 inches, on both sides of which may be written or otherwise reproduced in any order of arrangement:

  a. Code and Reg. section numbers, and any Code and Reg. page numbers.
  b. Quotations from and summaries of Code language and reg. language without limitation as to length.
  c. Any number of case names and ruling numbers, together with not more than five words with respect to each case or ruling. The limit of 5 is non-cumulative (i.e. you cannot list 3 words about one case and 7 about another case).

3. A hand-size calculator.
4. Pencils, erasers, and pens (preferably not felt-tip); erasures and cross-outs are entirely acceptable.

PROBLEM 1. Note: All subparts of this Problem 1 are independent of one another.

1a. Decedent Seller S, at a time when S's life expectancy was 27 years, sold Blackacre to an arms' length Purchaser P in return for P's personal liability promissory note for twenty (20) annual installment payments consisting of $25,000 per year of principal, plus interest at 90/6 per annum (which you are to assume is a legal and fair and reasonable rate) compounded annually and imposed upon the unpaid outstanding balance of principal. It was also validly provided in the written sales agreement and in the promissory note that after Seller has died the Purchaser need make no further payments to anyone (including the Seller's probate estate and the Seller's successors, beneficiaries, and assigns); this provision and all other terms of the sale were entirely reasonable and bona fide. S died 12 years later, and Purchaser P was relieved of the duty to make any further payments. Immediately before S's death the Fair Market Value (FMV) of the promissory note on which P was the debtor was $150,000, the face amount remaining unpaid immediately before death was $200,000, and S's income tax Adjusted Basis for the promissory note immediately before death was $80,000.

In an unrelated transaction, during life decedent S loaned $100,000 cash to his Brother Bob in return for Bob's personal liability promissory note that had a face amount at all times of $100,000, and which bore a fair rate of interest. Bob kept all interest paid on time, and immediately before S's death the unpaid balance of principal
was still $100,000 because no payments on principal had yet become due. This note had a FMV at all times of $90,000. All aspects of this loan transaction were genuine, bona fide, and on terms which equal those of an arms' length transaction.

S's valid will specifically provided that S by will "forgives, cancels, and otherwise forever gives up on behalf of himself, his executor, his probate estate, and all beneficiaries of his probate estate, all rights and claims against Bob with respect to the $100,000 promissory note upon which my Brother Bob is the debtor. All of my property remaining in my probate estate after paying all debts and expenses, I leave outright to my Sister Sal."

Analyze whether any amount is includible under Sec. 2033 in S's Gross Estate (GE) with respect to the promissory note of Purchaser P and with respect to the promissory note of Brother Bob. Disregard the dollar amount of any inclusion.

1b. Donor D established a new i*nter vivos* trust during D's lifetime that contains provisions which require an inclusion in D's GE under Sec. 2037 provided only that the FMV of D's reversionary interest in the trust has a Sec. 2037(a)(2) value greater than 5% of the value of the trust. D is in very bad health compared with the "average" person, but is not expected to die within one year. If D's actual life expectancy is determined by medical experts, this will prove that the actual value for D's reversionary interest at the date of his death is less than 5%. If D's life expectancy is determined by the actuarial tables in the ET regulations, this will prove that the actuarial value for D's reversionary interest is greater than 5%.

Analyze the extent to which Executor E of D's probate estate will succeed in employing D's actual health for the purpose of valuing D's reversionary interest for the Sec. 2037(a)(2) 5% test.

1c. During his lifetime Donor D established and funded an irrevocable and nonamendable *inter vivos* trust under which Bank B served as trustee. The trustee had discretion to distribute income and corpus to Donor D to provide for her education, medical care, food, clothing, shelter, and housing in the manner and style to which D had become accustomed immediately before the trust was established and funded. Donor D by an express provision in the trust instrument reserved to herself the authority to discharge the trustee with or without any cause whatever, and to substitute himself as successor trustee. D died in an automobile accident 5 years after establishing and funding the trust.

Analyze whether Sec. 2038(a)(2) requires an inclusion in D's GE.

1d. Prospective Grantor PG plans to establish an irrevocable and non-amendable trust for the benefit of her three adult children, A, B, and C; income is to be accumulated for fifteen (15) years, after which period the trust is to terminate and all trust property (i.e., all corpus and all accumulated income) is to be distributed outright in equal shares to A, B, and C. Under local law, A, B, and C do not need to survive the 15-year period in order to take. The partner in the law firm for which you work has asked you to advise him about only the Sec. 2503(b) Per Donee Exclusion (PDE) consequences to PG of including a provision authorizing A, B, and C, each acting alone and on his personal behalf, to demand that the Trustee, a bank, distribute to each of them one-third of the money and property contributed to the trust during the year in which the trust is initially funded and in each calendar year thereafter. The annual demand right is to be non-cumulative. The proposed trust language would require the bank as trustee to give each beneficiary prompt written notice of such contributions and inform them as to how much each may demand, and would provide that the beneficiary may exercise his or her withdrawal power within 60 day after receiving actual notice by delivering to the bank as trustee a signed written demand.

Disregard all tax consequences to the beneficiaries throughout this subpart.

Assume that without this proposed provision PG's gifts to the trust would all be fully taxable gifts and would not qualify for the Sec. 2503(b) PDE to any extent at all.

Concisely analyze for the partner the extent to which this proposed provision will qualify the client, PG, for the Sec. 2503(b) PDE. Analyze the likelihood that the Internal Revenue Service (IRS) will accept or resist your conclusion regarding the availability of the PDE by reason of this proposed trust language. Make **one** suggestion you believe advisable which would improve this proposed provision; your suggestion need not be to achieve a tax benefit, but may be to make the provision better suit the client's wishes.

1e. Employee E works for a large national corporation that pays all of the premiums for $200,000 of group term life insurance on the life of E. The corporation owns all rights, title, and interest to the underlying policy and pays all of the premiums. E is permitted to name the beneficiary, and E names his Cousin C as beneficiary. The day before E died, the FMV of the policy was only $200 because group term life insurance for a healthy person has very little value. When E died, the insurance company paid the face amount of $200,000 cash directly to C.

Very concisely analyze whether Sec. 2042(2) requires any inclusion in E's GE. Regardless whether you concluded that no amount is includible in E's GE, assume that an inclusion is required and explain the dollar amount includible.

PROBLEM 2.

Husband H was married to his first wife for ten years before they divorced; he refers to her as Witch W. They had one Child C, who is an adult. H has been married for many years to his present wife, who will become his Surviving Spouse SS. No children have been born to or adopted by SS. H owns separate property consisting of gold bars which H stores in a bank lockbox for safekeeping. H's Secs. 1012/1016 Adjusted Basis for the gold is $700,000 and the Fair Market Value (FMV) of the gold at the date of H's death (d/d) is $1,000,000. SS owns separate property registered in her own name alone consisting of $100,000 cash in a bank savings account. Assume that cash always has an Adjusted Basis and FMV equal to face.

Shortly after H died in 1997 his will was accepted into the probate court record. It provides that all of H's net estate shall be transferred to Trustee T to hold and administer as one new testamentary trust. All probate estate income beginning from the date that all estate debts have been paid in full, and all trust income beginning with the first day that the testamentary trust is validly formed and funded, is to be distributed monthly; 70% of such income is to be distributed ·to SS and 30% to adult Child C. Estate debts totaled $40,000, which H's Executor E paid in full four months after H's death; E raised this money by selling $40,000 FMV of gold bars. Five months after H's death, E transferred the $960,000 FMV at date distribution of remaining gold bars to Trustee T. Assume that throughout all subparts of this Problem the FMV of the gold bars will remain constant from H's d/d throughout the probate of H's estate, and assume that SS's $100,000 of separate property will remain constant in FMV throughout that same period of time. The FMV of the corpus in H's testamentary trust may increase between time Trustee T acquires that corpus and the time SS dies.

2a. The partner in your law firm is very worried that the Marital Deduction (MD) will be altogether unavailable regardless what Executor E may do by reason of the fact that gold bars do not produce any periodic income. Analyze the impact upon the availability of the MD of the fact that these gold bars are incapable of producing any periodic income. Do not go into anything else, such as whether SS's right to income is a Sec. 2056(b)(7)(B)(ii) Qualifying Income Interest (QII).

2b. Assume that the property in the estate and in the trust will produce enough income so that the MD is not impaired by reason of producing insufficient income. Analyze whether SS's income interest is a Sec. 2056(b)(7)(B)(ii) Qualifying Income Interest (QII). You may wish to remember that Sec. 20.2056(b)-7(d)(2) adopts the LE/GPOA regulations which you studied, Sec. 20.2056(b)-5(f), for determining whether a spouse's interest in income is sufficient to meet the statutory income interest requirements .

2c. Assume that SS' income interest is a QII, and that Executor E wishes to make a QTIP election which will produce the lowest possible marital deduction in H's estate that will assure two things: H's estate will pay no federal ET, and upon SS's future death her federal ET will be the lowest amount possible even in the event she acquires some additional property (other than the amount she received from H and the amount she already owned). Your answer will include the form or phraseology for the QTIP election, and will inform the partner exactly how many dollars will qualify for the MD.

2d. At the time SS dies, the FMV of all corpus in H's testamentary trust has increased in FMV to an aggregate of $1,300,000. Analyze the dollar amount, if any, that is includible in SS's GE by reason of the trust created by her Husband H (which trust distributed all of its corpus to Child C immediately after SS's death).

PROBLEM 3.

You will be asked only estate tax and gift tax questions about this problem; no income tax questions or issues will be raised. Grantor G on December 31 of year #1 transferred cash to Trustee T of a new irrevocable and non-amendable *inter vivos* trust which was to last for a fixed term of twenty (20) years. The trustee is required to use the cash to purchase and maintain trust investments which will produce a reasonable and proper amount of current income. All INCOME must be distributed monthly; the identity of the income distributees is as follows: 20% to B. 30% in whatever shares Grantor G may appoint during G's life among B, C, and D; and in default of any such appointment by G then such 30% shall be distributed in equal shares among B, C, and D. Although G must exercise her power of appointment during G's life (not by G's will), she may by so stating in her notice to T make her exercise effective for whatever income period she wishes, including any income period after as well as before she dies. / 40% in whatever shares Beneficiary B may appoint during B's life between Beneficiary B and E; and in default of any such appointment by B then such 40% shall be distributed all to E. Although B must exercise her power of appointment during B's life (not by B's will), she may by so stating in her notice to T make her exercise effective for whatever income period she wishes, including any income period after as well as before she dies. 10% to Grantor G.

There are no ascertainable standards or any other constraints on the exercise by G or B of their powers of appointment, and there is no way G can personally benefit from her exercise of her power of appointment over 30% of the income. The only thing G and B need to do to exercise their powers of appointment is to deliver a signed writing to T.

Upon expiration of the 20-year fixed trust term, the trust shall terminate and T is required to distribute all CORPUS outright in fee simple absolute to Remainderman R and his heirs. Nothing G, B. or anyone else can do will affect R's right to receive the full distribution of all corpus at the end of the 20-year term. T will not have any income to distribute to R because all income must be distributed to the income beneficiaries.

Each income beneficiary has an interest which will not be extinguished or otherwise affected by his or her death (except of course B and G cannot exercise either of their respective powers of appointment by will or after death). In other words, if an income beneficiary dies, his or her income interest continues in effect and his or her probate estate or testamentary successor will receive the share of income to which the deceased beneficiary would have been entitled had he or she not died.

In year #1, the amount of cash which Grantor G transferred to Trustee T was

$125,000. The actuarial value of the Remainder interest was 20% of the $125,000, or $25,000, and the aggregate actuarial value of all of the income interests taken together was 80% of the $125,000, or $100,000. The actuarial value of the various income interests alone can be determined by multiplying the percentages given above by the $100,000. Thus B's 20% fixed income interest is worth 20% times $100,000, or $20,000; the 30% B-C-D income interest is worth 30% times $100,000, or $30,000; the 40% B-E income interest is worth 40% times $100,000. or $40,000; and the 10% fixed income interest of Grantor G is worth 10% of $100,000, or $10,000. Throughout all years, you are to assume that these actuarial values remain the same (of course in reality they would shift throughout the 20-year term, but you are to ignore this), and you are to assume that throughout all relevant years in this problem the value of all trust corpus remains constant at the original $125,000.

Because G's year #1 transfer of cash was on December 31, there was no income received by T in year #1 and therefore no income was distributable or distributed in year #1. The trust produced $10,000 of net income each year, which was all distributed monthly during the year received by T to the correct income beneficiaries. During year #2, neither G nor B delivered any writing to T instructing T regarding distributions, and T therefore correctly distributed the $10,000 of income as follows: $2,000 to B pursuant to B's 20% fixed income interest; $1,000 each to B, C, and D ($3,000 aggregate) pursuant to the 30% share provision; $4,000 to E pursuant to the 40% share provision; and $1,000 to G pursuant to G's 10% fixed income interest.

3a. Analyze whether Grantor G has made any year #1 Taxable Gifts (TG), and to the extent you conclude there are TG's explain the dollar amount thereof.

3b. Disregarding the "5 or 5" exception, analyze whether Beneficiary B has made any TG in year #2, and to the extent you conclude there are TG's explain the dollar amount thereof.

3c. Throughout the remaining subparts of this problem, assume that all of the parties are still alive except the one party who has died. Thus if G is the decedent, assume that T, B, C, D, and E all survive G. Then if, in another subpart, B is the decedent, assume that G, T, C, D, and E all survive B, etc.

Grantor G died on January 1 of year #3, which is within 3 years of G's year #1 transfer of $125,000 cash to the trust. Treat each of the following subparts as an isolated question, and do not address the effect, if any, of your conclusion that another subpart (which may have involved a different Code section) also requires a Gross Estate (GE) inclusion.

3cl. Disregarding Sec. 2035(d)(2), analyze whether Sec. 2035 requires any inclusion in G's GE with respect to the original $125,000 transferred to the trust by G, identifying by description any interests or items includible but disregarding the dollar amount of any inclusions.

3c2. Analyze whether Sec. 2036(a) requires inclusion in G's GE, and to the extent you conclude that any GE inclusion is required, analyze the dollar amount thereof.

3c3. Analyze whether Sec. 2038(a)(1) requires inclusion in G's GE, and to the extent you conclude that any GE inclusion is required, analyze the dollar amount thereof.

3c4. Disregarding the "5 or 5" exception, and disregarding the Estate Tax (ET) consequences of any lapse during G's lifetime of any power of appointment, analyze whether Sec. 2041(a)(2) requires any inclusion in G's GE, disregarding the dollar amount of any inclusion.

3c5. Consistently with your answers to subpart a and all subparts of c above, analyze whether there will be any Adjusted Taxable Gifts (ATG), as that term is defined in Sec. 2001(b), in G's ET calculation, and to the extent you conclude that there are any ATGs, explain the dollar amount thereof. In the facts it was given that the dollar values of all assets remain the same at alltimes. Regardless whether you concluded that there is at G's death any ATG to be used in G's ET calculation, concisely analyze in *any other case where an ATG inclusion* <u>*is*</u> *required* whether the ATG inclusion will be based upon Fair Market Values (FMV) at the date of the *inter vivos* gift (d/g) or upon FMV at the date of death (d/d).