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Corrections were made to this workbook through January of 2014. No subsequent modifications were made.

ALTERNATIVE MINIMUM TAX AND ATRA

Alternative minimum tax (AMT) laws have been in existence since 1969. The minimum tax was enacted after Congress learned that 155 taxpayers with adjusted gross incomes (AGI) of $200,000 or more paid no federal income tax in 1966. The purpose of AMT was to prevent high-income taxpayers from exploiting the regular income tax system benefits available to lower-income taxpayers.

In 1987, the current AMT model was adopted. Under the AMT rules, a second method of calculating a taxpayer's income tax operates parallel to the "regular" tax system. After an individual's regular tax is calculated, the individual is required to calculate this "alternative" tax using different rates and definitions of income and deductions. Unfortunately, the 1987 model did not incorporate any adjustments for inflation.

With the lack of inflation adjustments and Congress's tendency to lower regular taxes without adjusting the AMT calculation, the AMT began to affect more and more middle class taxpayers. In the Taxpayer Advocate's 2003 Annual Report to Congress, Nina E. Olson stated that the AMT appears to function "randomly, no longer with any logical basis in sound tax administration or any connection with its original purpose of taxing the very wealthy who escape taxation. Congress must address the AMT before it bogs down tax administration and increases taxpayers' cynicism to such a level that overall compliance declines."[1]

Between 2003 and 2013, Congress repeatedly passed temporary "fixes" to AMT, which provided higher AMT exemption amounts and allowed certain tax credits to apply to both regular tax and AMT. However, each of these fixes expired within one or two years of enactment, making it difficult for taxpayers to plan appropriately.

Finally, on January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (ATRA), which **permanently** fixes the AMT problem for most taxpayers. Besides permanently increasing the AMT provisions, ATRA also permanently **indexes for inflation** the following AMT components.

- Exemptions
- Brackets
- Phaseout provisions

In addition, ATRA extends certain tax credits for both AMT and regular tax purposes and allows certain other tax credits to apply permanently to both types of income tax.

1. *2003 Annual Report to Congress.* National Taxpayer Advocate. Dec. 31, 2003. [www.irs.gov/pub/irs-utl/nta_2003_annual_update_mcw_1-15-042.pdf] Accessed on Aug. 21, 2013.

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Unlike regular income tax, the AMT calculation does not include any personal exemptions. The AMT exemption is applied to a tax return. The phaseout of personal exemptions reinstated by ATRA for regular tax purposes does not affect the calculation of AMT. Previously, the difference in the exemption amounts caused some taxpayers with large families to owe AMT even though every other item of income or deduction was treated the same for both taxes.

2013 AMT TABLES[2]

The following table shows the exemption amounts and phaseout floors for 2013.

Filing Status	2013 AMT Exemption	2013 AMT Exemption Phaseout (25% of AMTI Above...)
Married filing jointly (MFJ) or qualified widow(er) (QW)	$80,800	$153,900
Single	51,900	115,400
Married filing separately (MFS)	40,400	76,950
Estates and trusts	23,100	76,950

The following table summarizes the tax brackets for AMT income (AMTI).

Filing Status	26% Bracket AMTI Between...	28% Bracket AMTI Above...
MFJ or QW	$0–$179,500	$179,500
Single	0– 179,500	179,500
MFS	0– 89,750	89,750
Estates and trusts	0– 179,500	179,500

THE MECHANICS OF AMT

The calculation of a taxpayer's AMT starts with the taxpayer's AGI. If the taxpayer uses the standard deduction for regular tax purposes, all of this deduction is lost for AMT purposes. If the taxpayer itemizes, the total amount of the itemized deductions is subtracted from AGI, but the taxpayer may be required to add some of these deductions back into income for AMT purposes.

The following itemized deductions may be reduced or eliminated in the calculation of AMT income.

1. Medical and dental expenses (For AMT purposes, allowable medical expenses must exceed 10% of AGI. In 2013, the 10% floor applies for both types of taxes to taxpayers under age 65. Therefore, only taxpayers age 65 or older who are allowed to use the 7.5% floor are subject to this add-back.)
2. Taxes (100% add-back for most taxes)
3. Home mortgage interest (add-back based on use of mortgage proceeds)
4. Miscellaneous itemized deductions subject to the 2% floor (100% add-back)

Starting in 2013, itemized deductions for regular tax purposes are phased out for taxpayers whose income exceeds certain thresholds. However, the amount of the phaseout applied in the calculation of regular taxable income is ignored for AMT purposes.[3]

> **Note.** For more information about the phaseout of itemized deductions for higher-income taxpayers, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation.

[2] Rev. Proc. 2013-15, 2013-5 IRB 444.

[3] IRC §56(b)(1)(F).

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In addition to the modifications related to itemized deductions, there are approximately 20 other additions and subtractions that may be required, depending on the nature of the taxpayer's income and losses. These modifications are reported on lines 7 through 27 of Form 6251, *Alternative Minimum Tax — Individuals.*

Depreciation can cause multiple entries for AMT purposes. Depreciation rules vary for regular tax and AMT purposes. In the early years of an asset's life, regular depreciation may be more than AMT depreciation, so the excess is added back into AMT income. However, in later years, AMT depreciation may be more than regular depreciation, so the taxpayer is allowed to deduct the difference from AMT income.

If a taxpayer sells an asset for which the accumulated **regular** depreciation is different from the accumulated **AMT** depreciation, the taxpayer must modify AMT income for the difference in the gain or loss on the sale. If a taxpayer has a net operating loss (NOL) that includes depreciation, the taxpayer must make entries on Form 6251 for the NOL calculated under each tax system.

The items subject to modification for AMT purposes are called preferences[4] and adjustments.[5] Each has specific rules applicable to items in this category. Modifications resulting from timing differences may qualify the taxpayer for a credit in future years. This credit is calculated on Form 8801, *Credit for Prior Year Minimum Tax — Individuals, Estates, and Trusts.*

AMT AND CAPITAL GAIN TAX RATES[6]

For noncorporate taxpayers the Code allows the same tax rates that apply to qualified dividends, long-term capital gains, and unrecaptured IRC §1250 gains under regular tax to apply to AMT income. However, because of the AMT exemption phaseouts, taxpayers with large capital gains may be forced to pay AMT on their other income that is subject to ordinary tax rates.

Example 1. Marvin and Jessica are retired television stars. In 2013, both are 63 years old. They receive $12,000 from social security, and their combined pension income is $30,000. They also have interest income of $4,800. They file jointly and do not itemize.

Marvin owns 1,000 shares of stock in Iludiam Q-36, Inc., which he purchased in 1999 for a total of $30,000. (The stock is **not** qualified IRC §1202 small business stock.) Due to increased interest in space modulators as possible defense shields against rogue asteroids, the price of the shares has skyrocketed to $400 per share. Marvin consults with his tax advisor, Chuck, about the tax consequences of selling all the shares in 2013. Chuck makes the following calculations and concludes that the 2013 federal taxes due if Marvin sells all the shares will total $63,385. This includes $3,730 of AMT and $6,270 of Medicare tax on net investment income (NII).

> **Note.** For a thorough explanation of the Medicare tax on NII, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update.

4. IRC §57.

5. IRC §§56 and 58.

6. IRC §55(b)(3).

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If No Stock Is Sold in 2013

Item	Regular Tax	AMT
Interest	$ 4,800	
Long-term capital gain	0	
Pension income	30,000	
Taxable social security	4,400	
AGI	$39,200	$39,200
Less: standard deduction	(12,200)	
Taxable income before exemptions	$27,000	$39,200
Less: personal exemptions	(7,800)	
Less: AMT exemptions		(80,800)
Regular taxable income	$19,200	
AMT taxable income		$ 0
Income tax if no stock sold in 2013	**$ 1,991**	**$ 0**

If All Stock Is Sold in 2013

Item		Regular Tax	AMT
Interest		$ 4,800	
Long-term capital gain		370,000	
Pension income		30,000	
Taxable social security		10,200	
AGI		$415,000	$415,000
Less: standard deduction		(12,200)	
Taxable income before exemptions		$402,800	$415,000
Less: exemptions (phaseouts apply to regular tax)		(624)	(15,525)
Taxable income		$402,176	
AMTI			$399,475
Capital gains included in taxable income		(370,000)	(370,000)
Ordinary income		$ 32,176	$ 29,475
Tax on ordinary income		$ 3,934	$ 7,664
Capital gains taxes		49,451	49,451
2013 income tax		**$ 53,385**	**$ 57,115**
AMT	$ 57,115		
Less: regular tax	(53,385)		
AMT	$ 3,730	3,730	
Medicare tax on NII:			
(1) NII	$374,800		
(2) AGI in excess of $250,000	165,000		
Lesser of (1) or (2)	165,000		
Multiplied by Medicare contribution tax rate	× 3.80%		
Medicare tax on NII	$ 6,270	6,270	
Total taxes if all stock sold in 2013		$ 63,385	
Less: taxes if no stock sold in 2013 (from previous table)		(1,991)	
Total additional taxes if all stock sold in 2013		**$ 61,394**	

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Example 2. Assume the same facts as **Example 1.** In addition to calculating the 2013 taxes that will be due if all of the shares are sold, Chuck calculates the taxes assuming that only half of the shares are sold in 2013 and the rest are sold in 2014. If only half of the gain is realized in 2013, Marvin and Jessica will not owe any AMT or Medicare tax on NII. Their total taxes will equal $23,486. Assuming the shares maintain their high value, Marvin may want to wait until January 2014 to sell the remaining shares.

IRC §1202 allows the gain from the sale of qualified small business stock to be excluded from income. Previously, this gain was a preference item for AMT purposes and was added back to income in calculating AMTI. ATRA extends the qualifying acquisition dates to include stocks acquired before January 1, 2014, and retains the AMTI exclusion.

AMT TAX CREDITS

ATRA allows the following personal credits to reduce **both** regular tax and AMT.

1. Adoption credit[7] (5-year carryforward)
2. Child tax credit[8]
3. Credit for interest on certain home mortgages[9] (3-year carryforward)
4. American opportunity credit[10] (expires after 2017)
5. Hope and lifetime learning credits[11]
6. Saver's credit[12]
7. Residential energy efficient property[13] (expires after 2016)
8. New qualified fuel cell motor vehicle[14] (expires after 2014)
9. Qualified 2- or 3-wheeled plug-in electric vehicle[15] (expires after 2013)
10. Foreign tax credit[16]

Note. The following credits applied to both AMT and regular tax prior to ATRA and are still applicable to both.

1. Credit for child and dependent care expenses
2. Elderly or disabled credit

7. IRC §23.
8. IRC §24.
9. IRC §25(e).
10. IRC §25A.
11. Ibid.
12. IRC §25B.
13. IRC §25D.
14. IRC §30B.
15. IRC §30D.
16. IRC §904.

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INHERITED ASSETS[17]

Generally, assets that are inherited have a tax basis equal to the fair market value (FMV) at the time of the decedent's death. All taxpayers who inherit **qualified** property get step-up in basis. However, because of the high estate tax exemption ($5.25 million in 2013), only an estimated 3,800 estates will file and owe estate taxes in 2013.[18]

The **gross estate** includes all assets owned by the decedent, including the following.[19]

1. Real estate
2. Stocks and bonds
3. Cash, notes, and mortgages receivable
4. Insurance on the decedent's life
5. Works of art or collections valued in excess of $3,000
6. Certain property transferred during the decedent's life
7. Most annuities, retirement plans, and IRAs

Note. In this section, the terms "estate," "beneficiaries," and "heirs" are used interchangeably. Although there are technically legal differences in the terms, the tax results presented here are the same regardless of the legal definition of the process used to settle the decedent's affairs or the legal classification of the recipients of the decedent's assets.

The **beneficiary's tax basis** is generally equal to the FMV at the time of death which is determined by an appraisal or the best information available. The executor of an estate may choose to use the FMV on the date of death or on the **alternate valuation date.** The alternate valuation date is the date that is exactly six months after the date of death. The alternate valuation election may only be made if it lowers the overall value of the estate, lowers the estate tax, and is used for all assets in the estate. If the executor makes an alternate valuation date election, the beneficiary's basis is equal to the FMV of the property as of the alternate valuation date.[20]

INCOME IN RESPECT OF A DECEDENT[21]

Not all inherited assets are considered qualified property. There is a significant exception for **income in respect of a decedent (IRD).** In general, IRD is income that a decedent was entitled to receive but that was not properly includible in the **decedent's final income** tax return under the decedent's method of accounting. Instead, this income must be reported as taxable income by the recipient.

IRD includes the following.

1. All accrued income of a decedent who reported their income using the cash method of accounting
2. Income accrued solely because of the decedent's death in the case of a decedent who reported their income using the accrual method of accounting
3. Income to which the decedent had a contingent claim at the time of their death

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17. IRS Pub. 559, *Survivors, Executors, and Administrators.*

18. *Finally, a Permanent Estate Tax, Though Just for the Wealthy Few.* Feb. 7, 2013. Tax Policy Center. [http://taxvox.taxpolicycenter.org/2013/02/07/finally-a-permanent-estate-tax-though-just-for-the-wealthy-few] Accessed on Jul. 1, 2013.

19. Instructions to Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return.*

20. IRC §1014(a).

21. IRC §691.

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The following are some examples of IRD for decedents who reported their income using the cash method.

1. Unpaid wages that are payable to the decedent's estate
2. Uncollected interest on U.S. savings bonds
3. Income from installment agreements
4. Annuities, retirement plans, and IRAs

The IRD has the same character it would have had if the decedent had lived and received such amount. For example, if the IRD would have been a short-term capital gain if the decedent had lived, it is also included in the beneficiary's income as a short-term capital gain.

Unpaid Wages at Time of Death

The entire amount of wages or other employee compensation earned by the decedent but unpaid at the time of death is IRD. The income is not reduced by any amounts withheld by the employer. If the income is $600 or more, the employer should report it in box 3 of Form 1099-MISC, *Miscellaneous Income,* and give the recipient a copy of the form or a similar statement.

Wages paid as IRD are not subject to federal income tax withholding. However, if the wages are paid during the calendar year of death, they are subject to withholding for social security and Medicare taxes. These taxes should be reported on the decedent's Form W-2, *Wage and Tax Statement,* along with the taxes that were withheld before death. Wages paid as IRD are not included in box 1 of Form W-2.

Wages paid as IRD after the year of death generally are not subject to withholding for any federal taxes.

> **Example 3.** Tracy was entitled to a large salary payment as of the date of her death in January 2013. The amount was to be paid in five annual installments of $10,000 each, starting in March 2013. The sole beneficiary of her estate is her ex-husband, Lawrence. None of the salary payments are includible on Tracy's final return.
>
> The first payment is received by her estate. Her former employer withholds social security and Medicare taxes from this payment and reports wages in boxes 3, 4, 5, and 6 of Form W-2 using Tracy's social security number. The former employer also issues a Form 1099-MISC to the estate reporting gross federal taxable wages.
>
> The estate is closed in December 2013. Lawrence will receive the final four payments in 2014 through 2017. In each of these years, he should receive a Form 1099-MISC that shows $10,000 in box 3. The former employer should not withhold any taxes from these payments.

Unreported Interest on U.S. Savings Bonds

Interest on Series EE or series I U.S. savings bonds may be reported each year as it accrues. If the decedent reported the accrued interest each year, the interest earned from the first of the year up to the date of death must also be included on the decedent's final income tax return. The taxpayer who inherits the bonds reports only the interest earned after the date of death.

> **Note.** Prior to September 1, 2004, holders of EE/E bonds were allowed to exchange their bonds at maturity for HH/H bonds.[22] At that time, the investors could choose whether or not to report the interest that had accrued on the EE/E bonds. Many investors chose **not** to report the accrued interest. The elections discussed in this section also apply to the unreported interest used to purchase the HH/H bonds.

22. *HH/H Savings Bonds.* TreasuryDirect. [www.treasurydirect.gov/indiv/products/prod_hhbonds_glance.htm] Accessed on Jul. 1, 2013.

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Alternatively, a taxpayer who uses the cash method of accounting may defer reporting the interest until the bonds mature or are redeemed, whichever comes first. If the taxpayer chose not to report the interest each year, interest earned before death may be reported in one of the following ways.

1. The personal representative who files the decedent's final income tax return can elect to include all of the interest earned on the bonds up to the decedent's death on the return. The recipient then includes only the interest earned after the date of death on their return.

2. If the final return does **not** include the accrued interest, the interest earned from the purchase date up to the date of death is treated as IRD. All of the interest income earned from the purchase date to maturity or redemption is income to the taxpayer who inherits the bonds. However, in the year that the interest is reported, the recipient may claim a deduction on Schedule A, *Itemized Deductions,* for any federal estate tax paid related to the accrued interest. This is listed as a miscellaneous deduction **not** subject to the 2% floor.

Example 4. Abe, a cash-method taxpayer, dies in 2013 and leaves his nephew, Lanny, 50 series EE bonds with a face value of $1,000 each, for a total of $50,000. Abe bought the bonds for $500 each, for a total of $25,000 (50 × $500). He did not report any of the accrued interest on his annual income tax returns.

At the time of Abe's death, $20,000 of interest had accrued on the bonds. The total $45,000 value ($20,000 interest + $25,000 purchase price) is included in Abe's estate. The estate's executor does **not** include the $20,000 of accrued interest on the decedent's final income tax return.

Lanny is a cash-method taxpayer. He also chooses **not** to report the accrued interest each year. If he waits until the bonds reach maturity, he will report $500 interest income for each bond that he redeems. This $500 is the difference between the $1,000 face value and the $500 purchase price. Each year that he cashes any bonds, he is also entitled to claim a deduction for any federal estate tax that resulted from the inclusion of the bond's accrued interest in his uncle's estate.

Example 5. Use the same facts as **Example 4,** except the personal representative chooses to include the $20,000 of interest accrued on the bonds as of Abe's date of death on his final income tax return. For each bond that Lanny redeems at maturity, he reports interest income equal to the difference between the $1,000 face value and the value at the time of Abe's death.

An important exception applies to bonds that are used to satisfy a bequest of a specific dollar amount. In this case, only the interest earned after receipt of the bonds is income to the beneficiary. The interest earned up to the date of death plus any additional interest earned up to the date of distribution is income to the decedent and/or the estate.

Any Forms 1099-INT, *Interest Income,* issued to the taxpayer who redeems the bonds will show the entire amount of accrued interest, regardless of any election made by the taxpayer or the estate. The taxpayer who redeems the bonds should report the total interest shown on Form 1099-INT on their return. However, the amount that was previously reported should be subtracted from income. On the tax return, the subtraction should be identified as "U.S. Savings Bond Interest Previously Reported."

Observations.

1. Depending on the decedent's tax bracket compared to the tax brackets of the estate's beneficiaries, claiming the accrued interest on the decedent's final return can save the beneficiaries a significant amount of taxes.

2. Cash basis taxpayers make the election to include the accrued interest in income simply by including it on their returns. However, it may be beneficial for the return to clearly show that the interest is included under an IRC §454(a) election.

3. This election can also be an important tool in estate planning. A taxpayer with relatively low income may wish to make the election and pay the annual income taxes rather than leave the tax burden to heirs who are still in their peak earning years. This is particularly true if the heirs are subject to the Medicare tax on net investment income.

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> **Note.** The redemption values of U.S. savings bonds generally are available from local banks, credit unions, savings and loan institutions, the nearest Federal Reserve Bank, or at **www.treasurydirect.gov.** Information may also be obtained by writing to the following address.
>
> Bureau of the Public Debt
> Division of Customer Assistance
> P.O. Box 7015
> Parkersburg, WV 26106-7015

Installment Obligations

If the decedent sold property using the installment method, the payments received by the beneficiaries or the estate are taxed exactly as they would have been to the deceased. The same gross profit percentage that the decedent used applies to each payment received after death.

There are special rules that apply if the **debtor/buyer** inherits the receivable or if the debt is forgiven. If this happens, the estate must include in income:

1. The greater of:
   a. The amount received in settlement of the obligation, or
   b. The FMV of the installment obligation at the time of transfer,
2. **Less** the basis of the obligation.

The basis of the obligation is the decedent's basis, adjusted for all installment payments received after the decedent's death and before the transfer. If the decedent and obligor were related persons, the FMV of the obligation cannot be less than its face value.

> **Note.** For more information, see IRS Pub. 537, *Installment Sales*.

Annuities, Retirement Plans, and IRAs

Content related to annuities, retirement plans, and IRAs, is covered later in this chapter.

ASSETS THAT MAY RECEIVE SPECIAL TREATMENT

Decedent's Personal Residence

The basis of the decedent's personal residence is the FMV at the date of death. However, the tax treatment of the sale depends on how the estate holds or uses the former residence. Upon death, the house is considered a business, investment, or a personal-use asset, based on its use.

If the executor intends to sell the house, the residence is a capital asset held for investment. Therefore, any gain or loss is a capital gain or loss. Although the decedent would not have been able to deduct a loss on the sale of their personal residence, its use has changed the nature of the asset to an investment and therefore any capital loss on the sale may be deductible. The same is true if the estate converted the residence to rental property before selling it.

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Example 6. Gertrude was still living at home when she passed away on July 27, 2012. Her executor, Alice, put the house on the market as soon as possible after disposing of Gertrude's personal property and making repairs. At the time Gertrude passed away, the FMV of the home was $80,000. Unfortunately, the septic system needed replacing before the house could be sold, so the estate paid $5,000 to have a new system installed.

On April 30, 2013, the house sold for $90,000. The realtor's commission and other costs of selling the house totaled $7,000. The estate's basis and **capital loss** are calculated as follows.

Selling price		$90,000
FMV on date of death	$80,000	
Improvements	5,000	
Costs of sale	7,000 [a]	
Total basis	$92,000	(92,000)
Net capital loss		($ 2,000)

[a] Closing costs are not included in basis if the asset was sold in order to satisfy the expenses of the estate.

Note. The real estate taxes deducted from the proceeds are **not** included in the selling costs. These are deductible on line 11 (taxes) of Form 1041, *U.S. Income Tax Return for Estates and Trusts.*

The result is different if the house is **not** held for business or investment use. If it is sold without first converting it to business or investment use, any gain is a capital gain but a loss is **not deductible.**

Example 7. Tripp is living with his mother in the home she owns when she passes away. He is the sole beneficiary of her estate. At the time of her death, the FMV of the house is $130,000. Six months after her death, Tripp decides that he cannot live alone anymore. He sells the house and moves in with his girlfriend. He manages to sell the house for $130,000, but he pays $10,000 in closing costs. The $10,000 loss is **not** deductible because the residence was held for his personal use, rather than for investment or business use.

Individuals may gift their personal residences to other people prior to their death for various reasons. In this situation, the donor's original basis is often difficult to determine.

Gifts of Appreciated Property

There is a 1-year look-back period for gifts of appreciated property that are subsequently inherited by the person who made the gift. Property reacquired from the decedent does **not** receive a step up in basis. The beneficiary's basis is the same as the decedent's adjusted basis immediately before death.

Proceeds from Farm Products

How farm products are treated by the estate depends on several factors, including the following.

- Whether the products were already sold or delivered
- Whether the decedent was using the cash or accrual method of accounting
- Whether the decedent was an active farmer or a nonmaterially participating farm landlord

Products. All livestock, unharvested crops, and stored crops that are unsold and therefore owned by a deceased taxpayer are assets of the estate.[23] As explained later, the income tax treatment of the subsequent sale is determined by the nature of the farm activities of the deceased.

However, if the product has already been sold prior to death, the receivable is an asset of the estate. The accounting method used by the decedent for tax purposes determines which taxpayer must report the income.

[23] Rev. Rul. 58-436, 1958-2 CB 366.

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Cash Basis versus Accrual Basis. Cash basis taxpayers do not recognize income until payment has been received or constructively received. Therefore, any payment received after the taxpayer's death is reported at the estate level and not on the taxpayer's final return. For a cash basis taxpayer, the income tax treatment is determined by the nature of the decedent's farm activities.

Accrual basis taxpayers must recognize the income when the right to receive payment is fixed. Therefore, uncollected income from assets that have already been sold at the time of death is reported on the decedent's final return, regardless of when the payment is received. The estate is not required to report the sale on Form 1041.

Active Farmers versus Nonmaterially Participating Landlords. Unsold crops of active farmers are treated as inventory, and the estate of the farmer receives a step up in the basis of the product to the FMV at the time of death.[24] Unsold livestock, unharvested crops, and grain in storage all qualify as inventory. The subsequent sales of the inventory items are capital sales and not IRD.

However, if the decedent was a nonmaterially participating crop-share landlord, a portion of unsold crops that the decedent owned at the time of death is considered IRD, and a portion is post-death ordinary income to the landlord's estate.[25] If the decedent was a cash basis taxpayer, the income is included in the estate is income in the year that the crops are sold.

Note. Some tax scholars argue that a materially participating farm landlord is treated the same as an active farmer for these purposes.[26]

IRD and the Deduction for Estate Taxes Paid. For landlords, the accrued rent must be included in the decedent's estate. The IRD is determined by prorating the number of days in the rental period during the decedent's life over the number of days in the rental period.[27] If the estate pays estate tax, the taxpayer who reports the IRD rental income is entitled to a miscellaneous itemized deduction for the portion of the estate tax attributable to the IRD.

HSA, Archer MSA, or a Medicare Advantage MSA

The treatment of a health savings account (HSA), Archer medical savings account (MSA), or a Medicare Advantage MSA at the death of the account holder depends on who acquires the interest in the account. If the decedent's estate acquires the interest, the FMV of the assets in the account on the date of death is included in income on the **decedent's final return.** There is **no** corresponding estate tax deduction allowed against this income.

If the decedent's spouse is the **designated beneficiary** of the account, the account becomes the spouse's account. Any other beneficiary, including a spouse who is **not** the designated beneficiary, must include the FMV of the account on the date of death as income on the beneficiary's return for the year in which the decedent died. The amount included in income is reduced by any qualified medical expenses for the decedent paid by the beneficiary within **one year** after the decedent's date of death.

If the value of the account was included in a taxable estate, the recipient may claim a deduction on Schedule A for any federal estate tax paid on the account. This deduction is listed as a miscellaneous itemized deduction **not** subject to the 2% floor. However, this rule does not apply to the decedent's spouse.

24. Ibid.

25. Rev. Rul. 64-289, 1964-2 CB 173.

26. See e.g., *Tax Issues Associated with Unharvested Crops in a Decedent's Estate.* McEowen, Roger. Feb. 10, 2009. Center for Agricultural Law and Taxation, Iowa State University. [www.calt.iastate.edu/briefs/CALT%20Legal%20Brief%20-%20Tax%20Issues%20Associated%20 with%20Unharvested%20Crops.pdf] Accessed on Jul. 1, 2013.

27. Rev. Rul. 64-289, 1964-2 CB 173.

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Life Insurance Proceeds

Life insurance proceeds paid to a beneficiary after the death of the insured are usually not taxable. However, if the original owner sells the policy to the beneficiary, the gain from the proceeds is taxable to the purchaser.

If the proceeds are received in installments, **the interest received** with each installment is income to the recipient. If the beneficiary under an insurance contract is entitled to receive the proceeds in installments for the rest of their life without a refund or period-certain guarantee, the excluded part of each installment is determined by dividing the amount held by the insurance company by the beneficiary's life expectancy. If there is a refund or period-certain guarantee, the amount held by the insurance company for this purpose is reduced by the actuarial value of the guarantee.

Example 8. As the beneficiary of a life insurance policy, Sandy chooses to receive the $50,000 proceeds under a life-income-with-cash-refund option. She is guaranteed $2,700 a year for the rest of her life, which is estimated by mortality tables to be 25 years from the insured's death. The actuarial value of the refund feature is $9,000.

The amount held by the insurance company reduced by the value of the guarantee is $41,000 ($50,000 − $9,000). The part of each installment that represents a return of principal is $1,640 ($41,000 ÷ 25). The remaining $1,060 ($2,700 − $1,640) is interest income. If Sandy dies before receiving the entire $50,000, the amount payable to the refund beneficiary is **not** taxable.

Special-Use Valuation Property

IRC §2032A allows the executor of an estate to choose a special-use valuation of qualified small businesses and farm property. Instead of valuing the property at the FMV, the value is based on the continued use of the property by the family in the same activity as that of the decedent.

If qualified heirs buy the property from the estate, their basis is equal to the special-use value reported by the estate plus any gain recognized by the estate.

Real property used in a trade or business or a farm can be valued for estate tax purposes based on its use as a business property or farm instead of its FMV on the date of death or alternate valuation date.[28] The value of the real property as a business asset or farm asset may be very different than the property's FMV.

The maximum amount that property valued under §2032A can be reduced from its FMV is $1,070,000 (for 2013).[29] This amount is subject to an annual adjustment for inflation.[30]

The alternate valuation date election and the special use valuation election may both be made for the same estate if the estate qualifies for both of the elections.[31] If both elections are made, the calculated value must reflect the value as of the alternate valuation date.[32]

Note. For further details on the requirements that a business property or farm must meet for the special use valuation election, see IRC §2032A and related regulations.

Under certain conditions, some or all of the estate tax benefits obtained by using the special-use valuation are subject to recapture. Generally, an additional estate tax must be paid by the qualified heir if the property is disposed of, or is no longer used for a qualifying purpose, within 10 years of the decedent's death.

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28. IRC §2032A.
29. Rev. Proc. 2012-41, 2012-45 IRB 539.
30. IRC §2032A(a)(3).
31. Rev. Rul. 83-31, 1983-1 CB 225.
32. Rev. Rul. 88-89, 1988-2 CB 333.

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If qualified heirs buy the property from the estate, their basis is equal to the special-use value reported by the estate plus any gain recognized by the estate. If the heir must pay any additional estate tax, they can elect to increase their basis in the special-use valuation property to its FMV on the date of the decedent's death or on the alternate valuation date, if the alternate date was used for the estate return. If the heir elects to increase the basis, they must pay interest on the recapture tax for the period beginning nine months after the decedent's death until the date the recapture tax is paid.

Note. For more information on the recapture tax, see the Instructions for Form 706-A, *United States Additional Estate Tax Return.*

Jointly Held Property

The surviving owner's new basis for jointly owned property is calculated by adding the survivor's basis in the property to the value of the inherited part of the property.

Example 9. Donald Wunderbar and his sister Hillary Gutentag own, as joint tenants with right of survivorship, rental property that they purchased for $60,000. Hillary paid $15,000 (25%) of the purchase price, and Donald paid $45,000 (75%). Under local law, each had a **one-half interest in the income** from the property. When Donald died, the FMV of the property was $100,000.

Hillary's new basis in the property is calculated as follows.

Hillary's original purchase	$15,000
50% of depreciation allowed/allowable	(10,000)
Interest acquired from Donald (75% of $100,000)	75,000
Hillary's new basis	$80,000

If the property is owned by a **married couple** as tenants by the entirety or as joint tenants with right of survivorship post-1981, it does not matter how much each of the spouses paid for the property. In that situation, assuming that the decedent and spouse are the only joint tenants, exactly 50% of the FMV of the property is included in the decedent's gross estate. The surviving spouse's basis is equal to one-half of the basis at the time of death plus one-half of the FMV includible in the estate. For marital and joint tenancies created before 1977, it is possible that a full basis step up would occur upon the first spouse's death.[33]

GIFT TRANSACTIONS AND THE GIFT TAX

The 2013 annual audit plan of the Treasury Inspector General for Tax Administration (TIGTA) indicates that a TIGTA audit objective for the 2013 fiscal year is to "evaluate how well the IRS identifies potential areas of noncompliance on estate and gift tax returns."[34] Gift and estate tax compliance is the focal point of one of the TIGTA audits of IRS processes and procedures. These audits are generally done to evaluate whether IRS processes and procedures are being administered to ensure tax compliance. The IRS has also recently taken actions to identify unreported gifts.

Note. For information about the IRS gift tax return initiative, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Compliance Target Areas.

Given the efforts by TIGTA and the IRS to close the tax gap through additional enforcement of gift tax rules, it is essential for the tax practitioner to develop familiarity with the rules and forms associated with the gift tax and to be able to identify donative acts by clients that trigger gift tax liability and the requirement to file a gift tax return.

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33. *Gallenstein v. Comm'r,* 975 F.2d 286 (6th Cir. 1992).

34. TIGTA Fiscal Year 2013 Annual Audit Plan, p. 20.

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GENERAL GIFT RULES

IRC §2501 imposes a tax on gifts. The gift tax is not a tax on the gift property itself but rather is a tax on the transfer of that property.[35] Whether a transaction involves making a valid gift is therefore a threshold question in connection with whether the gift tax is implicated.

At common law, a valid gift has three elements.

1. The donor's intent to make a gift to the donee
2. The donor's delivery of the gift property to the donee
3. The donee's acceptance of the property as a gift

Donor Intent

Given the subjective nature involved in a donor's intent, determining intent is generally not relevant for gift tax purposes. Whether the gift tax applies to a transaction is based on the objective facts and circumstances of that transaction without regard to the motive of the donor.[36] As a general rule, the transfer of property is considered a gift to the extent that the FMV of the property transferred to the donee exceeds the value of any consideration the donee gives to the donor for that property.[37] However, if a transfer of property is bargained for by the parties within the ordinary course of business, the transfer is not considered a gift even if there is a substantial disparity between the FMV of the property transferred and any consideration given for it.

Donor Delivery

In addition to gifting property directly to the donee, the donor may make an indirect gift or transfer property to a trust.[38]

If a donor transfers less than an entire interest in the property, the gift tax applies to whatever interest is transferred to the donee.[39] If the donor retains some interest in the property transferred as a gift, however, the gift may be partially complete or entirely incomplete, depending on the facts and circumstances.[40] In order for there to be a complete gift of an interest that triggers the gift tax, the donor must relinquish dominion and control over that interest to the extent that the donor no longer has any power to control further disposition of the property.[41] A donor who transfers property has not made a complete gift if the donor retains the power to take back the property's ownership.

Indirect Gifts. An **indirect gift** is when a gift is made by the donor to the donee through another person or entity.

> **Example 10.** Alfred, Barbara, Charlene, and Douglas are equal shareholders of ABCD Corporation. On October 31, 2013, the corporation transfers ownership of some antique office furniture to Charlene. On the date of the transfer, the FMV of the antique office furniture is $100,000. Alfred, Barbara, and Douglas may have made an indirect gift to Charlene. Because Charlene already had a 25% interest in the furniture before the corporation transferred ownership to her, the indirect gift from the other three shareholders amounts to $75,000 ($100,000 × 75%).[42] Charlene's 25% interest ($25,000) will likely be construed as a distribution from the corporation to her.

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35. Treas. Reg. §25.0-1(b); Treas. Reg. §25.2511-2(a).
36. Treas. Reg. §25.2511-1(g)(1).
37. Treas. Reg. §25.2512-8.
38. IRC §2511(a).
39. Treas. Reg. §25.2511-1(e).
40. Treas. Reg. §25.2511-2(b).
41. Ibid.
42. Treas. Reg. §25.2511-1(h)(1).

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Donee Acceptance

In order for a transfer of property to be considered a gift, acceptance by the donee is a necessary element. A donee may renounce a gift by disclaiming that gift. If a **qualified disclaimer** is made by the donee, the disclaimed property interest is treated as if it were never transferred to the disclaiming donee under gift tax rules. A qualified disclaimer must be an irrevocable and unqualified refusal by the donee to accept the interest in property from the donor.

> **Note.** A disclaimer must meet certain requirements in order to be a "qualified disclaimer." For further details on those requirements, see IRC §2518(b).

Donated Services

It is the transfer of property that triggers the gift tax.[43] The gift tax does not apply to donated personal services.[44] However, if the donor initially requires payment for services from the donee and subsequently forgives the debt owed for services rendered, this may be a completed gift, resulting in gift tax liability.

If a trustee (or other fiduciary) waives fees to which they are entitled **after** the fiduciary services have been rendered, the waived fees:

- Constitute taxable income to the trustee and are includible in the trustee's gross income, and
- Constitute a gift from the trustee to the trust, which is subject to the gift tax.[45]

Example 11. Helena is the trustee for the John and Jane Smith Community Services Trust. She became the trustee in 2013. Although state law entitles Helena to an annual statutory fee for her trustee services, Helena never actually had the trust pay the fee to her because she is a close friend of the members of the Smith family who originally founded the trust.

While still serving as trustee, she signs an agreement with the trust on December 31, 2013, indicating her desire to waive all fees owed to her from the trust for 2013. The agreement also indicates that Helena is forgoing all annual fiduciary fees for 2014 onward. Because Helena agreed to forgo her 2013 trustee fee **after** she had rendered her services for that year, the 2013 fee is taxable to Helena and she must include that amount in her 2013 gross income. In addition, the 2013 fee is treated as a gift from her to the trust and this gift is subject to the gift tax rules. As the donor, she is responsible for any gift tax consequences. However, Helena may waive her right to trustee fees for 2014 and subsequent years without income or gift tax consequences because this is considered rendering gratuitous services to which neither income nor gift tax applies.

Basis Rules for Gifts

Generally, the donee's basis in property received as a gift is equal to the donor's basis.[46] However, if the value of the gifted property has declined in the donor's hands and the donor's basis is more than the FMV of the property at the time the gift is made, the FMV becomes the donee's basis for depreciation and loss calculation.[47]

Example 12. Craig is Carl's father. Craig has some stock in Zytek Industries, Inc., which he purchased in 2010 for $10,000. He gifts this stock to Carl on September 14, 2013. On the date the gift was made, the FMV of the stock is $40,000. For the gifted stock, Carl receives a $10,000 carryover basis from his father. This carryover basis applies if Carl later sells the shares.

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43. IRC §§2501(a); 2511(a).
44. *Comm'r v. J.A. Hogle*, 165 F.2d 352 (10th Cir. 1947).
45. Rev. Rul. 66-167, 1966-1 CB 20; Rev. Rul. 70-237, 1970-1 CB 13; Rev. Rul. 64-225, 1964-2 CB 15.
46. Treas. Reg. §1.1015-1(a).
47. Ibid.

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Example 13. Use the same facts as **Example 12,** except the FMV of Craig's stock in Zytek Industries, Inc., on September 14, 2013, is $3,000. Because the date-of-gift FMV is lower than Craig's basis, Carl's basis in the gifted stock is the date-of-gift FMV of $3,000 for determining loss.

Observation. In **Example 13,** if Carl's basis were the $10,000 carryover basis, Carl could sell the stock at its $3,000 FMV immediately after receiving the stock as a gift and claim a loss of $7,000 (that Craig could have claimed if Craig had sold the stock). The rule requiring Carl to use the date-of-gift FMV as his basis in this situation exists to prevent Craig from gifting the $7,000 tax loss to his son.

Gifting Appreciated Property. If property that has appreciated in value is gifted, a special rule allows the property's basis to be increased by the gift tax paid. However, the amount of the increase in basis is limited to the gift tax paid that is attributable to the net appreciation of the gifted property.[48] The net appreciation is the amount by which the date-of-gift FMV exceeds the donor's basis.[49]

Example 14. Use the same facts as **Example 12.** Because Craig's basis is $10,000 and the date-of-gift FMV is $40,000, Craig is gifting appreciated property for which a basis increase is allowed for the amount of any gift tax paid. The stock has appreciated $30,000 at the time the gift is made on September 14, 2013. If Craig paid $1,000 of gift tax on the transfer to Carl, the amount of gift tax paid on the transfer attributable to the net appreciation is $750 ($30,000 net appreciation ÷ $40,000 amount of gift × $1,000 gift tax paid). Carl is entitled to an increased basis of $10,750.[50]

Note. No guidance exists for situations in which the donor obtains a refund of gift tax paid. Presumably, the donee must reduce the gift tax basis adjustment amount by the amount of gift tax refunded to the donor, at least if the donee has retained the gift property and has not yet sold or otherwise disposed of it. If the property has been sold, the donee may be required to report additional gain.

If the donor's basis is equal to or greater than the date-of-gift FMV, there is no net appreciation and no basis adjustment is permitted for any gift tax paid by the donor.[51] In addition, when an upward basis adjustment is permitted, the donee is entitled to such an adjustment regardless of when the donor paid the gift tax.[52]

Note. If the donor makes multiple gifts during the tax year, the gift tax basis adjustment amount is allocated to each gift on a pro-rata basis based on the size of each individual gift relative to the total taxable gifts made during the year. See Treas. Reg. §1.1015-5(c)(3) for additional guidance.

This upward basis adjustment in connection with the gift taxes paid on gifted appreciated property is permitted by IRC §1015(d), which refers to gift taxes paid under Chapter 12. Chapter 12 of the Code contains the federal gift tax provisions. There is no provision for any basis adjustment for state-level gift taxes paid.

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48. IRC §1015(d)(6)(A).

49. IRC §1015(d)(6)(B).

50. Treas. Reg. §1.1015-5(c)(1).

51. Rev. Rul. 79-371, 1979-2 CB 294.

52. Treas. Reg. §1.1015-5(a)(1)(i).

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Liability for the Gift Tax

It is the donor who is primarily liable for the payment of gift tax.[53] A donor makes a **net gift** when the donor makes a gift with the requirement that the donee or other party pays the donor's gift tax liability on the gratuitous transfer. If a net gift is made and the donee or other party pays the gift tax, an economic benefit is conferred on the donor. The donor realizes taxable income to the extent of any gift tax paid in excess of the donor's basis in the property.[54] Case law exists regarding the donor's income inclusion in the following net gift situations.

- A grantor who transfers property to a trust and reserves the right to receive enough income to pay the gift tax on the transfer must include that receipt in gross income and is subject to income tax on that amount.[55]
- The amount used to pay the gift tax is taxable as grantor income if the grantor transfers property to a trust and requires the gift tax to be paid by the trustee out of trust income.[56]

If a couple agrees to use split gifts (explained later), they are jointly and severally liable for any gift tax.

CALCULATING THE GIFT TAX

In order to understand how the gift tax is calculated, it is first essential to become familiar with the following tax items that are used within the calculations.

- Annual exclusion
- Medical exclusion
- Education exclusion
- Charitable deduction
- Marital deduction
- Unified credit

Annual Exclusion

For 2013, the donor may exclude $14,000 of gifts made to each donee,[57] which is adjusted annually for inflation. (For 2012, the amount was $13,000.[58]) In order to qualify for the annual exclusion, however, the gift must be a gift of a present interest. Gifts of a future interest do not qualify for the annual exclusion.[59] "Future interest" means that the donee does not have the immediate right to use, possess, or enjoy the gifted property.[60] Restrictions or conditions placed on a gift by the donor may prevent that gift from being a present-interest gift. State law may be determinative of whether a gift is one of present or future interest.

If the annual exclusion that is available for the year for a donee is not used in whole or in part by the donor by the end of the tax year, it expires.

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53. IRC §2502(c).
54. *V.P. Diedrich v. Comm'r*, 643 F.2d 499 (8th Cir. 1981), *aff'd,* S.Ct. 457 U.S. 191 (1982).
55. *A.E. Staley, Jr. v. Comm'r*, 136 F.2d 368 (5th Cir. 1943), *cert. denied* 320 U.S. 786.
56. *Est. of C. R. Sheaffer v. Comm'r*, 313 F.2d 738 (8th Cir. 1963), *cert. denied* 375 US 818.
57. Rev. Proc. 2012-41, 2012-45 IRB 539.
58. Rev. Proc. 2011-52, 2011-45 IRB 701.
59. IRC §2503(b)(1).
60. Treas. Reg. §25.2503-3(a); Rev. Rul. 76-179, 1976-1 CB 290.

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Example 15. Corissa has three daughters and two sons. During 2013, Corissa gives $20,000 to each daughter and $7,000 to each son. All the cash gifts are gifts of a present interest and qualify for the annual exclusion. The first $14,000 given to each daughter is excludable from her 2013 taxable gifts and is exempt from gift tax. Because each son was given an amount under the $14,000 annual exclusion amount, the entire $7,000 given to each son is also excludable from Corissa's 2013 taxable gifts and is exempt from gift tax.

Example 16. Felix is sole shareholder of Downriver Industries, Inc. In 2013, he establishes a trust for his daughter, Tabitha. He gifts $4,000 to the trust and also gifts some non-income-producing stock in Downriver Industries, Inc., with a date-of-gift value of $300,000. The stock gift to the trust is subject to the condition that the corporation has the right to redeem the stock at the corporation's discretion. The cash gift of $4,000 is a present-interest gift, but the stock gift is not. Felix can use the 2013 annual exclusion of $14,000 to shelter the $4,000 cash gift. This leaves $10,000 of annual exclusion that he could use to make further gifts to the trust. Because the stock gift is not a present interest, it does not qualify for the annual exclusion amount.[61]

Example 17. Use the same facts as **Example 16,** except that before the end of 2013, Felix gifts ownership of an $8,000 term deposit to the trust. This additional gift is a present-interest gift to the trust and Felix can shelter this $8,000 under the remaining $10,000 of annual exclusion available to him in connection with gifts to the trust for 2013. This leaves $2,000 of the annual exclusion ($14,000 annual exclusion for 2013 − $4,000 cash gift − $8,000 term deposit). This remaining $2,000 will expire at the end of 2013 unless Felix makes one or more additional present-interest gifts before the end of the tax year against which this remaining $2,000 of exclusion may be applied.

Example 18. Brenda gifts an equal interest in her home to 16 people and she continues to live in the home as the sole resident. The gifts will come from the sale proceeds of her home, which she has placed on the market. Because none of the donees occupies the home and the home is not yet sold, these 16 gifts are a future interest in the unrealized sale proceeds. **None of the 16 gifts qualify for the annual exclusion.**[62]

A gift is a present-interest gift if it provides the donee with use and enjoyment. In contrast, a future gift is a gift that does not provide the donee with immediate use and enjoyment. A gift of a future interest is taxed without the use of the annual exclusion and its value is generally determined by the use of IRS actuarial tables.[63]

Gifts to a Minor. Gifts to a minor can qualify for the annual exclusion if the gift property and income, if any, from that property are expended by the minor or expended for the benefit of the minor. The gift may still qualify for the annual exclusion if the property and income, if any, will pass to the minor upon attaining age 21 or to the minor's estate if the minor's death occurs prior to age 21.[64]

Note. For further guidance on the use of the annual exclusion for gifts to a minor, see Treas. Reg. §25.2503-4.

61. This example is based on *C. Goldstein v. Comm'r*, 26 TC 506 (1956).

62. This example is based on *Estate of N.H. Babbitt v. Comm'r*, 87 TC 1270 (1986).

63. IRC §7520.

64. IRC §2503(c).

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Split Gifts. For married couples, each spouse is considered a separate taxpayer who has the annual exclusion amount available to them each year on a per-donee basis. Accordingly, spouses can agree to split their gifts to maximize the use of the annual exclusion amount available for the year for both spouses. If the spouses agree to split gifts for the year, each spouse is considered to make one-half of the gifts.[65] In order to split gifts, both spouses must be U.S. citizens or U.S. residents.[66] They must also be married at the time of the gift. If the spouses are married at the time of the gift but are divorced later in the tax year, the former spouses may still split gifts as long as neither person remarries during the remainder of the tax year.[67]

Example 19. Kevin and Kayla are married and have two daughters. Kevin gifts $20,000 to each daughter in 2013. Kevin can use his $14,000 per-donee annual exclusion amount to reduce his taxable gift to each daughter. Because the first $14,000 gifted to each daughter is excludable from 2013 taxable gifts, Kevin will have a $6,000 taxable gift to each daughter ($20,000 total gift per daughter − $14,000 annual exclusion). Kevin's total 2013 taxable gift amount to his daughters is $12,000 ($6,000 × 2 daughters).

Example 20. Use the same facts as **Example 19,** except Kevin and Kayla decide to split their gifts. Each spouse has a $14,000 annual exclusion to use for each daughter. Of the $20,000 gifted to each daughter, each spouse is considered to make half (or $10,000) of those gifts. Kevin's $10,000 gift to each daughter is entirely sheltered by the $14,000 annual exclusion. The same is true for Kayla. Kevin and Kayla's total gifts to their daughters are entirely exempt from gift tax.

Kevin and Kayla could each gift a total of $14,000 to each daughter before fully using their individual annual exclusions. This allows Kevin and Kayla to gift a total of $28,000 to each daughter with no gift tax, for a total of $56,000.

Medical Exclusion

There is an unlimited exclusion for medical expenses **paid directly** to the medical care provider[68] for qualifying medical expenses that are not reimbursed by insurance.[69]

Qualifying medical expenses are those expenses that qualify for the medical deduction under IRC §213(d) and include expenses for the following items.[70]

- Diagnosis, cure, mitigation, treatment, or prevention of disease
- Procedures affecting a structure or function of the body
- Transportation needed for medical care
- Long-term care
- Medical insurance or long-term care insurance premiums

> **Note.** No particular relationship needs to exist between the donor and donee in order for the medical expenses to qualify for the medical exclusion.

65. IRC §2513(a).
66. Ibid.
67. Ibid.
68. IRC §2503(e)(2)(B).
69. IRC §213(d)(1)(C), (D).
70. Treas. Reg. §25.2503-6(b)(3).

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Education Exclusion

An unlimited exclusion exists for tuition payments **paid directly** to a qualifying educational institution for the education or training of a donee.[71] A qualifying educational institution is defined as an institution that normally maintains a regular faculty and curriculum with a regularly enrolled body of students who attend on the premises where educational activities are conducted.[72] Payments to qualifying educational institutions outside the United States also qualify for this exclusion.[73] The unlimited exclusion is allowed for payments made to a prepaid tuition account with an educational institution.[74]

> **Note.** This unlimited educational exclusion is available to the taxpayer separately from the annual exclusion. Moreover, no particular relationship is required between the donor and donee in order to qualify for the use of this unlimited education exclusion. For additional guidance, see Treas. Reg. §25.2503-6.

Charitable Deduction

Charitable gifts made to qualifying charities are deducted from taxable gifts.[75] The amount of the deduction is limited to the amount of qualified charitable gifts made during the year. The annual exclusion must first be applied to qualifying charitable gifts before the charitable deduction is used.[76] Generally, qualifying charitable gifts for gift tax purposes include gifts that are to or for the use of the following.

- The United States, a state, territory, or any political subdivision of these, or the District of Columbia for exclusively public purposes
- A corporation, trust, community chest, fund, or foundation organized and operated exclusively for religious, scientific, literary, or educational purposes, including encouragement of art and the prevention of cruelty to children or animals
- A fraternal society or order if the gift is to be used exclusively for religious, scientific, literary, or educational purposes, including encouragement of art and the prevention of cruelty to children or animals or a combination of these purposes
- A war veteran's organization or auxiliary unit organized in the United States or a U.S. possession

> **Note.** Although the charitable deduction rules for gift tax purposes are similar to the charitable deduction rules for income tax purposes, some differences exist. For further guidance on the gift tax charitable deduction, see Treas. Reg. §25.2522(a)-1.

71. IRC §2503(e)(2)(A).
72. Treas. Reg. §25.2503-6(b)(2).
73. Rev. Rul. 82-143, 1982-2 CB 220.
74. IRS TAM 199941013 (Jul. 1999).
75. IRC §2524.
76. IRC §§2503(b), 2513(a).

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Marital Deduction

Generally, a gift between spouses qualifies for an unlimited deduction as long as the spouses are married at the time of the gift[77] and the donee spouse is a U.S. citizen.[78]

> **Note.** Gifts to a spouse who is not a U.S. citizen do not qualify for the unlimited marital deduction but rather may qualify for a special annual exclusion amount. For 2013, this annual exclusion is $143,000.[79] This amount is adjusted annually for inflation.

> **Observation.** The unlimited marital deduction provides a spouse with the ability to transfer an unlimited amount of assets to the other spouse without any gift tax and without any need for the donor to make use of the annual exclusion amount or unified credit (discussed later) in connection with spousal gifts.

However, a gift to a spouse does not qualify for the marital deduction if the gift is a **nondeductible terminable interest.** A nondeductible terminable interest is a gift to a spouse that another person may obtain when the spouse's interest in the gift property ceases to exist.

Example 21. George gifts a condominium in Florida to his wife, Loretta. He makes this gift by executing the deed in a manner that provides Loretta with a life interest in the condominium. Upon Loretta's death, the condominium will pass to Loretta's brother, Amos. This gift from George to Loretta is a nondeductible terminable interest and does not qualify for the unlimited marital deduction.

There are four exceptions to the rule on nondeductible terminable interests.

1. A life estate with which the donee spouse has a general power of appointment[80]
2. Qualified terminable interest property (QTIP)[81]
3. Charitable remainder trusts with the donor and donee spouse as the only noncharitable beneficiaries[82]
4. A joint tenancy with the right of survivorship[83]

These four items can qualify for the unlimited marital deduction.

> **Note.** For further guidance on nondeductible terminable interests and the four exceptions, see IRC §2523 and the underlying regulations.

77. IRC §2523(a).
78. IRC §2523(i).
79. Rev. Proc. 2012-41, 2012-45 IRB 539.
80. IRC §2523(e).
81. IRC §2523(f).
82. IRC §2523(g).
83. IRC §2523(d).

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Unified Credit

Under the gift tax rules that became effective with ATRA, an applicable exclusion of $5.25 million is provided for 2013. This lifetime exclusion is available to every taxpayer. It is adjusted annually for inflation. In addition to the other exclusions and deductions described in this section, this exclusion permits lifetime gifts up to $5.25 million (with indexing for inflation) without incurring gift tax. When a donor makes a gift, the annual exclusion is applied first before any amount of the unified lifetime credit amount is used to reduce the amount of gifting that is taxable.

Note. This exclusion is also sometimes referred to as an "exemption" or the "basic exemption" or "basic exclusion."

The following table provides the 2013 gift tax rates for taxable gifts. These rates and brackets also apply to the taxable amount of a donor's estate.

If the Taxable Estate or Gift Is			
Over	**But Not Over**	**The Federal Tax Is**	**Of the Amount Over**
$ 0	$ 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

Using this table, the amount of gift tax that would be paid on $5.25 million of taxable gifts is as follows.

Tax on the first $1 million of gifts	$ 345,800
Tax on the next $4.25 million of gifts ($4.25 million × 40%)	1,700,000
Total tax on $5.25 million of gifts	$2,045,800

For 2013, the $5.25 million exclusion provides a tax credit to the donor of $2,045,800. This is referred to as the **unified tax credit.**

Note. This tax credit is referred to as the "unified" credit because it applies to both the donor's taxable gifts made while the donor is alive and to the donor's estate at death. More information on this subject is provided later in this chapter.

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The applicable exclusion and corresponding unified credit are subject to an inflation adjustment. The following table summarizes the amount of each for the 2011, 2012, and 2013 tax years along with the top tax rate applicable to taxable gifts.

For Decedents Dying or Gifts Made During	Top Tax Rate	Applicable Unified Credit	Exemption Equivalent
2011	35%	$1,730,800	$5,000,000
2012	35%	1,772,800	5,120,000
2013	40%	2,045,800	5,250,000

Note. The unified credit equals the tax at that year's gift tax rate that would be payable on the basic exclusion amount. The basic exclusion is sometimes erroneously referred to as the "unified credit."

The Unified Credit and Estate Tax. The unified credit is important not only during the donor's lifetime but also at death. Generally, whatever amount of unified credit the donor has not yet used at the time of death to eliminate taxable gifts may be used in connection with the donor's estate.[84] In addition, the **portability** provision associated with the unified credit allows a donor to use the available unified credit that was not used by the previously deceased spouse during the spouse's lifetime or at death.[85] The unused spouse's unified credit is referred to as the "deceased spousal unused exclusion" (DSUE) amount. A surviving spouse may use this to reduce or eliminate gift tax or estate tax. The amount of any DSUE applied against gifts or estate assets is reported on the appropriate gift tax or estate tax return.

If no exclusion, deduction, or exemption applies to the gift and the donor has no further unified credit (or DSUE from a deceased spouse) available, the gift triggers tax liability. The applicable tax brackets and rates for gifts are progressive, with a maximum rate of 40% for 2013 and subsequent years.

Gift Tax Liability

The gift tax rates shown previously apply to the cumulative sum of taxable gifts made over the donor's lifetime. Gift tax liability is calculated using the following steps.

1. The current year's taxable gifts must be calculated. This is done using the following formula.

	Total gifts for the current year
–	Exclusions (annual exclusion, education exclusion, and medical exclusion)
–	Deductions (marital deduction, charitable deduction)
	Current year's taxable gifts

2. The current year's taxable gifts are added to all prior lifetime taxable gifts to calculate the total lifetime gifts.

3. Tentative tax amounts are calculated on the total **lifetime** gifts and on all taxable gifts made in **prior** years. Once these two tentative tax amounts have been calculated using the gift tax table for the current year, the tax on the current year's taxable gifts is found using the following formula.

	Tentative tax on lifetime gifts
–	Tentative tax on all prior lifetime gifts
	Gift tax liability on current year taxable gifts

[84] IRC §2010(c).

[85] IRC §2010(c)(4).

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Note. The tentative tax calculations are completed using gift tax rates and brackets in effect for the current year (without regard to what the past gift tax rates or brackets were in the prior years in which the gifts were made.)[86] Therefore, current gift tax rates are, in effect, applied retroactively on past years' gifts to calculate the current year's gift tax.

The donor may use any available unified credit to offset some or all of this tax liability on current year gifts. If required, the donor must report the gift and the applicable deduction or exclusion on Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return.* The filing requirements for Form 709 are discussed later in this chapter.

Example 22. Norman has substantial assets and was advised by his tax professional in 2012 to begin a program of annual gifting to reduce the size of his estate at death. Norman and Nora are divorced and have two adult daughters, Margie and Marnie, who are 28 and 23 years of age, respectively. Margie married in November 2012 and Marnie lives at home with her parents while she finishes her engineering degree at a local university.

Norman also has a close friend, Lisa, who is a widow confined to a local hospital. Because Lisa's assets have been depleted by substantial medical costs, Norman pays her hospital bills.

In addition, Norman paid Marnie's $32,000 tuition bill. Norman made the following cash gifts to his daughters. The amount indicated for Marnie includes the $32,000 tuition amount. The table also includes the amounts paid for Lisa's hospitalization.

	Amount	Date of Gift
Margie	$140,000	November 16, 2012
Marnie	292,000	November 16, 2012
Lisa	22,000	Various

Norman follows the advice given by his tax professional to pay Marnie's tuition bill directly to the university. Norman also paid the hospital directly in connection with Lisa's hospital bills as he was advised.

In addition to the previously mentioned gifts, Norman gifted a house to Margie as a wedding present. This home was purchased by Norman in 2001 as an investment property. He also had a car that he gifted to Marnie for her to use as transportation to school. Both of these gifts were also made on November 16, 2012. Norman's cost basis in the house and car and the FMV of these assets on the date of gifting follows.

Gift Asset	Norman's Basis	FMV on November 16, 2012
House to Margie	$100,000	$155,000
Car to Marnie	25,000	3,000

The 2012 tax year is the first year that Norman made any gifts. Because Norman made taxable gifts in excess of the annual exclusion amount of $13,000 (for 2012), a Form 709 must be filed in connection with the taxable gifts.

86. IRC §2502(a); Treas. Reg. §25.2502-1(a), (b).

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Norman's gift tax is calculated by first determining the total value of all gifts for 2012. The total gifts are then reduced as follows to arrive at taxable gifts.

Total gifts for the current year
– Exclusions (annual exclusion, education exclusion, and medical exclusion)
– Deductions (marital deduction, charitable deduction)

Current year's taxable gifts

Because Norman paid Marnie's $32,000 tuition directly to the university, this qualifies for the educational exclusion. Moreover, because Norman paid the hospital directly in connection with Lisa's hospitalization costs, the $22,000 paid qualifies for the medical exclusion. Norman also is entitled to claim the 2012 annual exclusion of $13,000 in connection with each daughter. These items are reflected in the following table, which shows the calculation of total taxable gifts made by Norman for 2012.

Gift Asset	Margie	Marnie	Lisa	Total
Cash	$140,000	$260,000		$400,000
Tuition		32,000		32,000
House (FMV on Nov. 16, 2012)	155,000			155,000
Car (FMV on Nov. 16, 2012)		$ 3,000		3,000
Payment of hospital bills			$22,000	22,000
Total gifts for 2012	$295,000	$295,000	$22,000	$612,000
Less: qualifying medical exclusion			(22,000)	(22,000)
Less: qualifying educational exclusion		(32,000)		(32,000)
Total gifts after exclusions	$295,000	$263,000	$ 0	$558,000
Less: annual exclusion	(13,000)	(13,000)		(26,000)
Total taxable gifts for 2012	$282,000	$250,000		$532,000

Because Norman did not made any taxable gifts prior to 2012, he can use the full 2012 unified credit of $1,772,800 against the gift tax that would otherwise be payable on the $532,000 of 2012 taxable gifts. The relevant parts of Norman's 2012 gift tax return follow.

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For Example 22

Form **709** Department of the Treasury Internal Revenue Service

United States Gift (and Generation-Skipping Transfer) Tax Return

▶ Information about Form 709 and its separate instructions is at *www.irs.gov/form709*.

(For gifts made during calendar year 2012)

▶ See instructions.

OMB No. 1545-0020 **2012**

Part 1—General Information

1 Donor's first name and middle initial: Norman	2 Donor's last name: Cloverly	3 Donor's social security number: 999-99-9999
4 Address (number, street, and apartment number): 348 Kenwood Court		5 Legal residence (domicile)
6 City, state, and ZIP or postal code: Grosse Pointe Farms, MI 48236		7 Citizenship (see instructions): U.S.

Line	Item	Yes	No
8	If the donor died during the year, check here ▶ ☐ and enter date of death ____ , ____ .		
9	If you extended the time to file this Form 709, check here ▶ ☐		
10	Enter the total number of donees listed on Schedule A. Count each person only once. ▶ 2		
11a	Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b		X
b	Has your address changed since you last filed Form 709 (or 709-A)?		
12	**Gifts by husband or wife to third parties.** Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (see instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. **If the answer is "No," skip lines 13–18.**)		
13	Name of consenting spouse — 14 SSN		
15	Were you married to one another during the entire calendar year? (see instructions)		
16	If 15 is "No," check whether ☐ married ☐ divorced or ☐ widowed/deceased, and give date (see instructions) ▶		
17	Will a gift tax return for this year be filed by your spouse? (If "Yes," mail both returns in the same envelope.)		
18	**Consent of Spouse.** I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent. **Consenting spouse's signature ▶** **Date ▶**		
19	Have you applied a DSUE amount received from a predeceased spouse to a gift or gifts reported on this or a previous Form 709? If "Yes," complete Schedule C		X

Part 2—Tax Computation

Line	Description	Line	Amount
1	Enter the amount from Schedule A, Part 4, line 11	1	532,000
2	Enter the amount from Schedule B, line 3	2	
3	Total taxable gifts. Add lines 1 and 2	3	532,000
4	Tax computed on amount on line 3 (see *Table for Computing Gift Tax* in instructions)	4	167,000
5	Tax computed on amount on line 2 (see *Table for Computing Gift Tax* in instructions)	5	
6	Balance. Subtract line 5 from line 4	6	167,000
7	Applicable credit amount. If donor has DSUE amount from predeceased spouse(s), enter amount from Schedule C, line 5; otherwise, see instructions	7	1,772,800
8	Enter the applicable credit against tax allowable for all prior periods (from Sch. B, line 1, col. C)	8	
9	Balance. Subtract line 8 from line 7. Do not enter less than zero	9	1,772,800
10	Enter 20% (.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (see instructions)	10	
11	Balance. Subtract line 10 from line 9. Do not enter less than zero	11	1,772,800
12	Applicable credit. Enter the smaller of line 6 or line 11	12	167,000
13	Credit for foreign gift taxes (see instructions)	13	
14	Total credits. Add lines 12 and 13	14	167,000
15	Balance. Subtract line 14 from line 6. Do not enter less than zero	15	0
16	Generation-skipping transfer taxes (from Schedule D, Part 3, col. H, Total)	16	
17	Total tax. Add lines 15 and 16	17	0
18	Gift and generation-skipping transfer taxes prepaid with extension of time to file	18	
19	If line 18 is less than line 17, enter **balance due** (see instructions)	19	
20	If line 18 is greater than line 17, enter **amount to be refunded**	20	

Attach check or money order here.

Sign Here

Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☒ No

Signature of donor — Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see the instructions for this form. Cat. No. 16783M Form **709** (2012)

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For Example 22

Form 709 (2012) Page 2

SCHEDULE A **Computation of Taxable Gifts** (Including transfers in trust) (see instructions)

A Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation . . . . Yes ☐ No ☑

B ☐ ◄ Check here if you elect under section 529(c)(2)(B) to treat any transfers made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

Part 1—Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions. (see instructions)

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1	See Attachment		525,000		558,000		558,000
Gifts made by spouse —*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 1. Add amounts from Part 1, column H . . . ▶							558,000

...Direct Skips. Gifts that are direct skips and are subject to both gift tax and generation-skipping transfer tax. You must list the gifts in...

Form 709 (2012) Page 3

Part 4—Taxable Gift Reconciliation

				Line	Amount
1	Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3			1	558,000
2	Total annual exclusions for gifts listed on line 1 (see instructions)			2	26,000
3	Total included amount of gifts. Subtract line 2 from line 1			3	532,000
Deductions (see instructions)					
4	Gifts of interests to spouse for which a marital deduction will be claimed, based on item numbers ______ of Schedule A	4			
5	Exclusions attributable to gifts on line 4	5			
6	Marital deduction. Subtract line 5 from line 4	6			
7	Charitable deduction, based on item nos. ______ less exclusions	7			
8	Total deductions. Add lines 6 and 7			8	
9	Subtract line 8 from line 3			9	532,000
10	Generation-skipping transfer taxes payable with this Form 709 (from Schedule D, Part 3, col. H, Total)			10	0
11	**Taxable gifts.** Add lines 9 and 10. Enter here and on page 1, Part 2—Tax Computation, line 1			11	532,000

...minable Interest (QTIP) Marital Deduction. (see instructions for Schedule A, Part 4, line 4)

For 2012, Norman's taxable gifts of $532,000 triggered $167,000 gift tax liability, however Norman used $167,000 of the $1,772,800 unified credit to eliminate that liability. The amount of the unified credit that Norman has available in 2013 and subsequent years to offset further gift tax liability is reduced by the amount of the credit used in 2012.

Observation. Norman's use of the unified credit to offset gift tax liability is **mandatory.**[87] Even though Norman has no gift tax liability after applying the unified credit, he is still required to file a 2012 gift tax return in connection with his 2012 taxable gifts.

87. IRC §2505.

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Example 23. After making the 2012 taxable gifts and filing his 2012 gift tax return as shown in **Example 22,** Norman decides to continue his gifting program in 2013. During 2013, he makes a $264,000 cash gift to each of his two daughters.

Norman's tax professional calculates the amount of unified credit he has available for 2013 (after using $167,000 of that credit to eliminate his 2012 gift tax). The following table summarizes the 2012 and 2013 basic exclusion and unified credit amounts.

	Basic Exclusion Amount	Unified Credit Amount	Annual Exclusion Amount
2012	$5,120,000	$1,772,800	$13,000
2013	5,250,000	2,045,800	14,000

For 2013, Norman made the following total gifts.

	Margie	Marnie	Total
Total gifts for 2013	$264,000	$264,000	$528,000
Less: annual exclusion	(14,000)	(14,000)	(28,000)
Taxable gifts for 2013	$250,000	$250,000	$500,000

Norman's 2013 taxable gifts must be added to all prior lifetime taxable gifts to calculate the total lifetime gifts. Norman's total lifetime gifts are $1,032,000 ($532,000 for 2012 and $500,000 for 2013).

Next, the tentative tax amount is calculated on the total lifetime gifts and on all taxable gifts made in prior years. Using the table shown earlier in this chapter, Norman's tentative tax on his total lifetime gifts is $358,600. The tax liability shown on his 2012 Form 709 was $167,000, which was applied against his unified credit. Norman's gift tax liability on his current year taxable gifts (which is applied against his unified credit) is calculated as follows.

Tentative tax on lifetime gifts	$358,600
Tentative tax on 2012 gifts	(167,000)
Gift tax liability on 2013 taxable gifts	$191,600

Example 24. Use the same facts as **Example 23,** except Norman and Nora are married. In order to maximize the use of their annual exclusions (and reduce taxable gifts), Norman and Nora may agree to split their gifts. If the spouses split gifts, each spouse is considered to make half of the gifts to each daughter and each spouse is entitled to claim a $14,000 annual exclusion in connection with their respective gifts. Use of gift splitting results in each spouse making the following gifts and claiming the following annual exclusions for Margie.

	To Margie from Norman	To Margie from Nora	Margie Total
Total gifts for 2013	$132,000	$132,000	$264,000
Less: annual exclusions	(14,000)	(14,000)	(28,000)
Taxable gifts for 2013	$118,000	$118,000	$236,000

The taxable gift amounts for Marnie are the same as those shown above for Margie.

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Using split gifts results in total taxable gifts of $472,000 ($236,000 for each daughter) instead of taxable gifts of $500,000 that resulted when Norman was the sole donee. Nora is able to claim two additional annual exclusions of $14,000 (one for each daughter), which allows both spouses to shelter an additional $28,000 of gifts.

In order for Norman to use a split-gift strategy, he must obtain Nora's consent. Nora's consent is entered on Form 709, part 1, lines 12 through 18. Her signature is required.

Nora is also required to file a Form 709 in connection with her portion of the split gifts. Filing requirements are covered in the next section. The first page of Nora's return must show Norman's consent to split the gifts and requires Norman's signature. Each spouse reports their respective share of gifts on their Form 709.

Note. It is not necessary for spouses to split all gifts. Spouses may select which gifts to split. Schedule A of the Form 709 indicates which particular gifts are split.

FILING REQUIREMENTS

Generally, if a donor makes a gift to a donee in excess of the annual exclusion, a gift tax return must be filed.[88] However, no return is required in connection with gifts that:

- Are made to political organizations,
- Qualify for the educational exclusion, or
- Qualify for the medical exclusion.

These types of gifts do not trigger a filing requirement and are never shown on Schedule A of Form 709.

Generally, a taxpayer who is a U.S. citizen or resident must file a Form 709 if during the year the taxpayer:

- Made total gifts to a nonspouse donee that exceeded the annual exclusion amount attributable to that donee,
- Made a gift of a future interest, or
- Wishes to split gifts with a spouse.[89]

There is no joint gift tax return. Accordingly, each spouse is required to file their own gift tax return if required to do so. A gift return must be filed by the donor to split gifts with the other spouse. (Gift splitting is discussed earlier in this chapter.) With split gifts, the other spouse must also file a gift tax return unless the gifts attributable to each spouse do not exceed the annual exclusion amount. However, if any of the split gifts constitutes a gift of a future interest, both spouses must file. Split-gift returns should be mailed by the spouses in the same envelope to assist with IRS processing of the returns and to avoid unnecessary IRS correspondence.[90]

The filing requirement must be met by the donor regardless of whether there is any gift tax liability.[91]

Note. Only individual taxpayers file gift tax returns. If an entity — such as an estate, trust, or corporation — makes a gift, the beneficiaries or shareholders are considered the donors and the filing requirements apply to them. Similarly, if a partnership makes a gift, the partners are considered the donors. The entity has no gift tax return filing obligation.

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88. Instructions for Form 709.
89. Ibid.
90. Ibid.
91. Ibid.

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If the only gift made during the year is a donation of an entire interest in the donor's property, and the donor is eligible for the charitable deduction for gift tax purposes (discussed earlier), a Form 709 need not be filed. However, if only a partial-interest gift was made or if part of a gift was donated to charity and the other part was donated to another party, a Form 709 is required and all charitable donations must be disclosed.[92] In addition, if a filing requirement is triggered because of a noncharitable gift and the donor also made charitable gifts that would not otherwise trigger the filing requirement, all noncharitable and charitable gifts must be shown on the return.[93]

Filing Deadline

Form 709 is an annual return for the year in which a filing requirement exists. It must be filed between January 1 and April 15 in the year following the year in which the gift was made.[94] The taxpayer may obtain an extension of the deadline for filing Form 709 in the following ways.

- Obtaining an extension for the taxpayer's Form 1040 using Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, or Form 2350, *Application for Extension of Time To File U.S. Income Tax Return* (An extension for Form 1040 automatically serves as a Form 709 extension.)
- Filing Form 8892, *Application for Automatic Extension of Time To File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax*

Both methods serve as extensions for the time to file but do not extend the time to pay the gift tax liability. Form 8892 is also a payment voucher to use in paying gift taxes prior to filing the gift tax return. If the gift tax liability is not paid by the original Form 709 due date, interest accrues and penalties may be assessed.[95]

INHERITING RETIREMENT ASSETS

Generally, all types of qualified retirement plans, including IRAs, are subject to required minimum distribution (RMD) rules. These rules determine how the amount in each account is distributed during the account owner's lifetime. These rules also apply after the account owner's death when the account is inherited by another individual or entity.

Note. The RMD rules apply to all employer-sponsored retirement plans — such as profit-sharing plans, 401(k) plans, 403(b) plans, and 457(b) plans — as well as to traditional IRAs, SEP IRAs, SARSEPs, and SIMPLE IRAs.[96]

The RMD rules are based on the account owner's **required beginning date (RBD).** The RBD is generally April 1 of the calendar year following the later of:

- The calendar year in which the account owner attains age 70½, or
- The calendar year in which the account owner retires.[97]

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92. Ibid.
93. Ibid.
94. Ibid.
95. Instructions for Form 8892.
96. *Retirement Plans FAQs regarding Required Minimum Distributions*. [www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Required-Minimum-Distributions#2] Accessed on Jun. 19, 2013.
97. IRC §401(a)(9); Treas. Reg. §1.401(a)(9)-1.

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In the case of an owner of a traditional IRA or an account owner who owns more than 5% of the employer providing the qualified plan, the RBD is April 1 of the calendar year following the year in which that person attains age 70½. (The actual retirement date is irrelevant.) The account owner owns more than 5% of an employer if they own more than 5% of the issued stock or voting power (if the employer is incorporated) or more than a 5% interest in the capital or profits of the business (if the employer is not incorporated).[98]

> **Note.** For purposes of the 5%-owner rule, special attribution rules apply to family-owned businesses under IRC §318.[99]

While the account owner is alive, any amount in the qualified plan that has not been distributed by the account owner's RBD must be paid over a period based on the life expectancy of either:

- The account owner, or
- The account owner and a designated beneficiary spouse jointly if the spouse is more than 10 years younger than the account owner.[100]

During the life of the account owner, the **uniform lifetime table** is used to determine each year's RMD under the following circumstances.

- The plan holder is a single individual
- The account owner is married with a spouse who is not the sole designated beneficiary
- The account owner is married with a spouse who is the sole designated beneficiary and not more than 10 years younger than the account owner[101]

> **Note.** Although the RMD is typically calculated by the retirement plan administrator or IRA custodian, the account owner is primarily responsible for the calculation of the RMD each year.[102]

98. IRC §416(i)(1)(B)(i).

99. See IRC §416(i)(1)(B)(iii).

100. IRC §401(a)(9)(A); Treas. Reg. §1.401(a)(9)-5. The preamble to the regulations indicates that the joint life expectancy table may be used if the spouse is more than 10 years younger. In addition, the joint life expectancy table is based on a spouse being 10 years younger.

101. Treas. Reg. §1.401(a)(9)-9.

102. *Retirement Plans FAQs regarding Required Minimum Distributions*. [www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Required-Minimum-Distributions#2] Accessed on Jun. 19, 2013.

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The RMD is generally determined by starting with the account balance at the end of the preceding tax year. That amount is divided by the appropriate distribution period found in the uniform lifetime table.[103] The uniform lifetime table from IRS Pub. 590, *Individual Retirement Arrangements (IRAs),* follows.

Appendix C. Uniform Lifetime Table

Table III
(Uniform Lifetime)

(For Use by:
- **Unmarried Owners,**
- **Married Owners Whose Spouses Are Not More Than 10 Years Younger, and**
- **Married Owners Whose Spouses Are Not the Sole Beneficiaries of Their IRAs)**

Age	Distribution Period	Age	Distribution Period
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and over	1.9

If the account owner's spouse is more than 10 years younger than the account owner and that spouse is named as sole beneficiary, then the **joint life and last survivor table** is used instead of the uniform lifetime table.[104] The joint and survivor table is also found in IRS Pub. 590. If the IRA owner's spouse is more than 10 years younger and the owner names that spouse as a designated beneficiary along with other beneficiaries, the uniform lifetime table must be used. This rule also applies to other qualified plans.

> **Note.** Further guidance on RMDs and the life expectancy tables may be found in IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*

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103. IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*

104. Ibid.

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Example 25. Minnie's 70th birthday is June 30, 2013. She attains age 70½ on December 30, 2013. Her 2013 RMD does not have to be made until her required beginning date of April 1, 2014. However, her 2014 RMD must be taken on or before December 31, 2014. Similarly, in each tax year subsequent to 2014, each RMD in connection with the tax year must be taken on or before December 31 of that year. If Minnie decides to wait until sometime in 2014 (on or before her April 1, 2014, RBD) to receive her 2013 RMD, she will receive two taxable RMDs in 2014. It may be best for her to take the 2013 RMD before the end of 2013 to avoid receiving two RMDs in 2014.

Example 26. Clare is single and his date of birth is November 1, 1942. He reaches age 70½ in 2013. His RBD is April 1, 2014. At the end of 2012, his IRA has a balance of $106,000. Using the uniform lifetime table, an individual Clare's age (age 71 for purposes of the table) has a life expectancy of 26.5 years. Clare's 2013 RMD is $4,000 ($106,000 ÷ 26.5 years). Because this will be Clare's first RMD, he may choose to receive that distribution on or before the end of 2013 or wait until sometime between January 1 and April 1, 2014.

Note. Roth IRA accounts are not subject to RMD rules during the account owner's lifetime.

If the owner has multiple IRAs, the RMD for each account is calculated separately. However, the total combined RMDs can be taken from any of the accounts.

REQUIRED MINIMUM DISTRIBUTIONS AFTER ACCOUNT OWNER'S DEATH

After the death of the account owner, the RMD rules vary depending on the following factors.

- Whether there is a designated beneficiary for the plan
- Whether there is a beneficiary who is a surviving spouse, individual, or entity
- Whether the account owner's death occurs before or after the account owner reached their RBD
- The terms of the retirement plan that address distribution methods available at the death of the account owner

Designated Beneficiary

The account owner can name another person or an entity (such as a charity, an estate, or a trust) as the beneficiary that will receive part or all of the account owner's interest in the retirement account after the account owner's death.

Entities may be named as beneficiaries, but they are not designated beneficiaries. A **designated beneficiary** is a natural person. The name of the person need not be specified, as long as the person is identifiable.[105] In addition, the person must be identified by September 30 of the year following the account owner's death in order to be considered a designated beneficiary.[106]

Inherited Traditional IRAs

A surviving spouse may elect to treat a deceased spouse's IRA as their own as long as the IRA is considered to be directly received. This is not true for an **inherited IRA.** If someone other than the decedent's surviving spouse receives the decedent's IRA as beneficiary, the IRA is an inherited IRA.

The beneficiary of an inherited IRA is subject to RMD rules, cannot make additional contributions to the IRA, and cannot roll over the IRA. If a beneficiary receives a lump-sum distribution from a traditional IRA that they inherited, all or some of it may be taxable. The distribution is taxable in the year received. However, if the decedent made nondeductible contributions to the IRA, the recipient is also allowed to exclude this basis from income.

Note. For additional details and strategies regarding inherited IRA accounts, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 5: Retirement. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

105. Treas. Reg. §1.401(a)(9)-4.

106. Ibid.

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Surviving Spouses and IRA

Upon the death of an IRA owner, the IRA passes to the one or more named beneficiaries (with the previously discussed RMD rules applying to the distributions on the account after the death of the IRA owner).

A surviving spouse who is the sole designated beneficiary of an IRA may elect to treat the IRA account as their own. This is true even if both spouses have attained ages past their RBDs at the time of the deceased spouse's death.[107] The surviving spouse is the only individual who can make an election to treat the IRA as their own.[108] This election is considered made if one of the following conditions is met.

- The surviving spouse becomes the new owner named on the IRA.
- The amount that would be required to be distributed to the surviving spouse as beneficiary is not distributed before the required deadline.
- The surviving spouse makes additional contributions to the IRA.[109]

Surviving spouses have the option to roll over the distribution instead of claiming the income at the time they inherit the IRA. A surviving spouse can roll over the taxable part of the distribution into any of the following.

- Traditional IRA
- Qualified plan
- §403(b) employee annuity
- §457 plan for employees of tax-exempt organizations and state and local governments

General Rules after the Account Owner's Death

The RMD rules that apply after the death of the account owner depend on whether the account owner died before or after reaching their own RBD for the retirement plan.

Death before RBD. Generally, if the account owner's death occurs **before** the account owner's RBD, any remaining retirement plan benefit is subject to either the **5-year rule,** the **life expectancy rule,** or the **special spousal rule.** The terms of the retirement plan itself has an impact on which rule applies.[110]

To determine whether the 5-year rule, the life expectancy rule, or the special spousal rule applies, the terms of the retirement plan must be reviewed. The retirement plan must use the same distribution rules for all plan participants.[111] The retirement plan may specify that the 5-year rule applies after the account owner's death even if the account owner has named a designated beneficiary.[112]

If the plan terms contain **no provision** specifying how distributions are to be made following the account owner's death, distributions must be made using:

- The special spousal rule if the designated beneficiary is the surviving spouse,
- The life expectancy rule if there is any other designated beneficiary, or
- The 5-year rule if there is no designated beneficiary.[113]

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107. Ltr. Rul. 199948039 (Sep. 1999).

108. Treas. Reg. §1.408-8.

109. Ibid.

110. Treas. Reg. §1.401(a)(9)-3.

111. Ibid.

112. Ibid.

113. Ibid.

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The plan may also provide either the account owner or a beneficiary with the option to elect the 5-year rule, life expectancy rule, or special spousal rule if there is a designated beneficiary. If so, special rules and time limits apply to making the election.[114]

- Under the **5-year rule,** the entire interest in the retirement plan of the deceased account owner must be distributed by the end of the year in which the fifth anniversary date of the account owner's death occurred.[115]
- Under the **life expectancy rule,** the interest in the retirement plan must be distributed over the life expectancy of the beneficiary.[116] Distributions must begin on or before the end of the calendar year following the year in which the account owner died.[117]
- If the spouse is the designated beneficiary, the **special spousal rule** indicates that the retirement plan does not need to begin distributions until the **later of:**
  - The end of the calendar year following the account owner's year of death, or
  - The end of the calendar year in which the account owner would have reached age 70½.[118]

Note. Generally, these rules apply to a Roth IRA after the death of the account owner. See IRS Pub. 590 for further guidance.

Death after the RBD. If the account owner's death occurs **after** the account owner's RBD, the general rules are as follows.

1. If there is no designated beneficiary, the distribution period is the remaining life expectancy that the account owner would have had based on their age in the year of death.
2. If there is a nonspousal designated beneficiary, RMDs are based on the longer of the following.
   a. The remaining life expectancy of the account owner
   b. The remaining life expectancy of the designated beneficiary (using the beneficiary's age in the year following the account owner's death)
3. When a spouse is the beneficiary, RMDs are based on the surviving spouse's life expectancy using the surviving spouse's date of birth for each calendar year after the calendar year in which the account owner died.[119]
4. RMDs of a deceased individual, if not distributed by the date of death, **must be** distributed by yearend.

Note. Although the RMD rules are designed to limit the length of time funds can be held within a retirement plan (and to ensure funds are distributed and taxed each year), a retirement plan may make it possible for a beneficiary to receive funds from the account at a pace more accelerated than the applicable RMD rule would provide (including a lump-sum distribution). However, at the very least, an RMD must be taken. For further details and guidance in connection with RMDs after the death of an account owner, see Treas. Reg. §1.401(a)(9)-2 and Treas. Reg. §1.401(a)(9)-5.

114. Ibid.
115. IRC §401(a)(9)(B)(ii).
116. IRC §401(a)(9)(B)(iii).
117. Treas. Reg. §1.401(a)(9)-3.
118. Ibid.
119. Treas. Reg. §1.401(a)(9)-5.

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The RMD rules for a nonspousal beneficiary differ from those rules that apply to a spousal beneficiary. A summary of the rules applicable to each (and for beneficiaries that are entities and, therefore, are not designated beneficiaries) follows.[120]

Required Minimum Distributions for IRA Beneficiaries

<table>
<tr><th rowspan="2"></th><th colspan="3">Designated Beneficiary</th></tr>
<tr><th>Spouse only</th><th>Non-spouse</th><th>No designated beneficiary (including an estate, charity, or some trusts)</th></tr>
<tr><th rowspan="3">IRA owner dies on or after required beginning date</th><td>• Spouse may treat as his/her own, or</td><td rowspan="3">• Distribute using Table I
• Use younger of 1) beneficiary’s age or 2) owner’s age at birthday in year of death
• Determine beneficiary’s age at year-end following year of owner’s death
• Use oldest age of multiple beneficiaries
• Reduce beginning life expectancy by 1 for each subsequent year
• Can take owner’s RMD for year of death</td><td rowspan="3">• Table I
• Use owner’s age as of birthday in year of death
• Reduce beginning life expectancy by 1 for each subsequent year
• Can take owner’s RMD for year of death</td></tr>
<tr><td>• Distribute over spouse’s life using Table I*
• Use spouse’s current age each year, or</td></tr>
<tr><td>• Distribute based on owner’s age using Table I
• Use owner’s age as of birthday in year of death
• Reduce beginning life expectancy by 1 for each subsequent year
• Can take owner’s RMD for year of death</td></tr>
<tr><th rowspan="3">IRA owner dies before required beginning date</th><td>• Spouse may treat as her/his own; or</td><td rowspan="2">• Take entire balance by end of 5th year following year of death, or</td><td rowspan="3">• Take entire balance by end of 5th year following year of death</td></tr>
<tr><td>• Take entire balance by end of 5th year following year of death, or</td></tr>
<tr><td>• Distribute based on Table I
• Use spouse’s current age each year
• Distributions do not have to begin until owner would have turned 70 1/2</td><td>• Distribute based on Table I
• Use beneficiary’s age at year-end following year of owner’s death
• Reduce beginning life expectancy by 1 for each subsequent year</td></tr>
</table>

* Table 1 - Single Life Expectancy, Appendix C, Publication 590, *Individual Retirement Arrangements (IRAs)*.

IRS Pub. 590 provides a single life expectancy table for nonspousal beneficiaries to be used with an inherited IRA. This table is different from the uniform lifetime table used by IRA owners and the joint life and last survivor table that may be used by an owner with a spouse more than 10 years younger (which were discussed previously).

120. *Required Minimum Distributions for IRA Beneficiaries.* [www.irs.gov/pub/irs-tege/rmd_chart.pdf] Accessed on Jul. 17, 2013.

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Estate Planning Considerations

Naming a spouse as the direct beneficiary on an IRA or other retirement account is often the simplest option because the surviving spouse may easily accomplish a rollover of the deceased spouse's funds into appropriate accounts within their own retirement portfolio. This provides tax deferral through the use of the marital deduction (discussed earlier in this chapter). The surviving spouse may also further defer tax by delaying distributions, subject to the RMD rules that apply to the spouse, and by designating subsequent beneficiaries on the funds originally received from the deceased spouse.

Naming a trust as a beneficiary on a retirement plan or IRA account may be preferable if some degree of management or oversight is desired for providing a surviving spouse with distributions. As a general rule, if the proceeds of a decedent's qualified retirement plan or IRA pass through a trust or other third party before being distributed to the surviving spouse, the surviving spouse is deemed to have received the proceeds from the third party and not from the deceased spouse. This not only precludes a rollover of funds but requires the surviving spouse to include the entire proceeds in taxable income.

One private letter ruling involved a deceased husband's IRA proceeds that were first passed to a trust. The trustees had discretion to distribute the proceeds to the surviving spouse. The IRS held that the trust was the recipient of the IRA proceeds, not the surviving spouse. The surviving spouse could not roll over the proceeds into her own IRA and had to include the IRA proceeds in her gross income for the year.[121]

However, the IRS provided a contrasting decision in another letter ruling. A surviving spouse received IRA proceeds that first passed to a trust in which the trustees did not have discretion over how to direct the IRA proceeds. The IRS concluded that the proceeds were received from the husband due to his death. The IRS indicated that the surviving spouse was able to roll over the IRA proceeds received from the trust into an IRA of her own and, accordingly, was not required to include the proceeds in income for the year.[122]

Based on these two letter rulings, trustee discretion over the distribution of IRA proceeds seems determinative. The absence of trustee discretion may provide an exception to the general rule that IRA proceeds passing first into a trust and subsequently to the surviving spouse constitutes the receipt of the proceeds from a third party.

In addition, the IRS has provided an exception when the trustee is the surviving spouse.[123] An exception has also been granted when the surviving spouse has the authority to revoke the trust and cause trust assets, including IRA proceeds, to revert back to the surviving spouse.[124]

The exception was also deemed available in a situation in which co-trustees (the surviving spouse and a corporate trustee) had discretion over the distribution of IRA proceeds received by a trust. After one year, the surviving spouse had the power to remove the corporate trustee. After the 1-year period, the IRA proceeds were distributed to the surviving spouse and were rolled over into an IRA. The IRS noted that the Tax Court found that a person with unrestricted power to remove a trustee has the same power as the trustee because of the ability to substitute the removed trustee with another trustee that will follow the person's directives.[125] The IRS concluded that because the surviving spouse had this removal power, the co-trustees did not have sufficient discretion over the IRA proceeds to preclude a rollover. The surviving spouse had the benefit of the exception because, in this situation, the IRA proceeds are considered to be received from the deceased spouse and not from the trust.[126]

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121. Ltr. Rul. 9416045 (Jan. 30, 1994).

122. Ltr. Rul. 9416039 (Jan. 26, 1994).

123. Ltr. Rul. 201212021 (Dec. 27, 2011).

124. Ltr. Rul. 9811008 (Dec. 16, 1997).

125. *Corning v. Comm'r*, 24 TC 907 (Aug. 18, 1955), *aff'd* 239 F.2d 646 (6th Cir. 1956).

126. Ltr. Rul. 9426049 (Apr. 12, 1994).

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In addition, the surviving spouse is considered to receive the IRA proceeds directly from the deceased spouse and may treat the proceeds as their own if the surviving spouse is the ultimate beneficiary of the IRA under the terms of the trust.

Example 27. After Frank died, the proceeds of his IRA passed into a trust. The trust was structured so that his surviving spouse, Matilda, was the trustee and primary beneficiary. Matilda can roll over the proceeds from Frank's IRA into her own IRA.[127] The IRA proceeds are treated as being received by Matilda directly from Frank, because Matilda is the ultimate beneficiary of the trust.

Example 28. When Thelma died, her IRAs named her estate as the beneficiary. The proceeds of the IRAs passed to the residuary trust that was specified in her will. Her husband, Theodore, disclaimed his interest in Thelma's residuary trust and also obtained valid disclaimers from all of their children and the other remaining heirs. After obtaining all of the disclaimers, Theodore became the beneficiary of the IRAs under the state's intestate law. Theodore is entitled to roll over Thelma's IRA proceeds into his own IRA portfolio.[128]

The IRS has also held that rollover treatment is allowed when the surviving spouse is the sole executor of the deceased spouse's estate and the sole beneficiary of the estate.[129]

Note. Although private letter rulings may not be used as precedent, they are indicative of how the IRS may view the same or similar fact patterns involving other taxpayers.

Qualified Terminable Interest Property Trusts. For gift and estate purposes, the marital deduction is not available for nondeductible terminable interests. Therefore, if the interest in a property, such as an IRA, passes to the surviving spouse and that interest subsequently will pass to another person when the spouse's interest terminates (due to the occurrence or failure of some event or contingency), the property interest passing to the spouse is a terminable interest for which the marital deduction cannot be claimed. This presents a disadvantage for taxpayers who wish to provide their spouse with only a life income interest in IRA proceeds.

Example 29. Rodney is married to Barbara and has two adult children from a previous marriage. He is 61 years old and, during his career as an engineer, he accumulated approximately $2 million in IRAs. His will provides Barbara with a life income interest in the IRA accounts. Upon Barbara's death, the IRAs will pass to Rodney's two children in equal shares. Upon Rodney's death, Barbara's life interest in the IRA is a nondeductible terminable property interest for which the marital deduction cannot be claimed for estate purposes.

In order to use the marital deduction, a life income interest may be provided to a spouse using a qualified terminable interest property (QTIP) trust. QTIP is property that passes from the deceased spouse to a trust in which the surviving spouse has a qualifying life income interest. In order for property to be recognized as QTIP, an **election** under IRC §2056(b)(7)(B)(v) is required.[130] In addition, the spouse receiving the QTIP must be given a **qualifying life income interest.** A qualifying life income interest exists if:

- The surviving spouse is entitled to all of the income from the property payable no less frequently than annually, and
- No one is given the power to appoint any part of the property to someone other than the surviving spouse.[131]

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127. See Ltr. Rul. 9302022 (Oct. 19, 1992); Ltr. Rul. 9235058 (Jun. 4, 1992); Ltr. Rul. 200928043 (Apr. 14, 2009).

128. See Ltr. Rul. 9615043 (Jan. 17, 1996).

129. Ltr. Rul. 9450042 (Sep. 23, 1994).

130. IRC §2056(b)(7)(B)(i).

131. IRC §2056(b)(7)(B)(ii).

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Making the Election. A QTIP election may be made for gift tax or estate tax purposes in order to maximize use of the marital deduction. Once the election is made, it is irrevocable.[132]

The QTIP election for **estate** tax purposes is made on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return.* The election is made by listing the terminable interest's property value on Form 706, Schedule M.[133] If the terminable interest property for which a QTIP election is desired is listed with corresponding values on Schedule M, a presumption arises that a QTIP election has been made.[134]

The QTIP election for **gift** tax purposes is made on Form 709 by:

- Listing the gifted property on Schedule A for which a QTIP election is being, and
- Deducting the total value of the QTIP property listed on Schedule A, part 4, line 4, as property for which the marital deduction is being claimed.

Once these steps are completed on the Form 709, a presumption arises that a QTIP election was made for the property by the taxpayer.[135]

> **Example 30.** Use the same facts as **Example 29.** During 2013, Rodney files a gift tax return and makes a QTIP election for the IRAs at a time when the IRAs are still valued at $2 million. The unlimited marital deduction can be claimed for the $2 million of IRA assets. Rodney pays no gift tax on the transfer to Barbara. Upon Rodney's death, the IRAs do not pass into his estate. Rodney places the IRAs into a QTIP trust arrangement with terms that provide for Barbara's life income interest. The terms of the QTIP trust are drafted to ensure that, upon her death, the remainder of the IRAs pass to Rodney's children.

INHERITED ROTH IRAs

Qualified distributions from a Roth IRA are **not** subject to tax. A distribution made to a beneficiary or an estate is a qualified distribution if it is made after the 5-tax-year period beginning with the first tax year in which a contribution was made to any Roth IRA of the original owner.

Any distribution that is **not** a qualified distribution is includable in the beneficiary's income. However, the beneficiary is allowed to exclude the portion of the distribution that represents the original owner's contributions.

Required Minimum Distributions

Generally, the entire Roth IRA must be distributed by the end of the fifth calendar year after the year of the original owner's death unless it is payable to a designated beneficiary over their life expectancy. These distributions must begin before the end of the calendar year following the year of death.

If the sole beneficiary is the decedent's spouse, the spouse can delay the distributions until the decedent would have reached age 70½. The spouse also can opt to treat the Roth IRA as if it were originally in the spouse's name.

> **Note.** For more information on inherited IRAs, see IRS Pub. 590, *Individual Retirement Arrangements (IRAs).*

132. IRC 2056(b)(7)(B)(v).
133. Form 706 instructions.
134. Ibid.
135. Form 709 instructions.

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INHERITING A PARTNERSHIP INTEREST

Upon the death of a partner, the tax year of the partnership closes. The closing date is the deceased partner's date of death.[136] At the time of the death, the partner's interest in the partnership passes to the partner's successor in interest. Generally, the partner's successor in interest is the estate, unless the partner designates another successor in interest under a partnership agreement.[137] Such a designation is effective for tax purposes.[138]

The death of a partner serves to close the tax year for the partnership, but it does not terminate the partnership and only one partnership return is required for the year. Although a technical termination takes place when 50% or more of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, the transfer of a greater-than-50% partnership interest by gift or inheritance **does not** result in a technical termination.[139] The partnership does not terminate, because the successor in interest is treated as a partner (and may actually be a successor partner). Termination of a 2-partner partnership does not occur when one of the partners dies if the successor in interest continues to share in the profits or losses of the business.[140]

ALLOCATION OF INCOME IN THE YEAR OF DEATH

The closing of the partnership tax year due to the death of a partner requires the allocation of the distributive share of income, gain, loss, deduction, and credit items among the partners. For the tax year in which death occurs, the deceased partner's tax year (for which a final return is filed) ends on the date of death.[141] The deceased partner's distributive share of partnership income or loss attributable to this final tax year must be reported on the deceased partner's final return.[142] The amount of income or loss attributable to the after-death portion of the tax year should be reported by the successor in interest (which may be the deceased partner's estate). This allocation of distributive shares to the partners is done using either:

- An interim closing of the partnership books on the date of death, or
- Another method agreed upon by the partners.[143]

An interim closing of the books serves to divide the tax year into two short years (with the first short year ending on the deceased partner's date of death).

Other forms of income attributable to the deceased partner may be considered income in respect of a decedent (IRD). IRD consists of income rights of the deceased partner that should not be reported on the deceased partner's final tax return.[144] IRD attributable to the deceased partner is reported by the successor in interest. IRD with respect to a deceased partner may include the following.

- Guaranteed payments or a distributive share of partnership income under IRC §736(a) received by the successor in interest
- Individual assets of the partnership that, if held by the deceased partner personally, would constitute IRD (such as unrealized cash basis receivables)

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136. IRC §706(c)(2)(A).

137. Treas. Reg. §1.706-1(c)(3)(iii).

138. Ibid.

139. Treas. Reg. §1.708-1(b)(2).

140. Treas. Reg. §1.708-1(b)(1)(i).

141. Treas. Reg. §1.443-1(a)(2).

142. IRC §706(c)(2)(A).

143. Treas. Reg. §1.706-1(c)(2)(ii).

144. IRC §691.

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The successor in interest reports the IRD items when received.[145] In addition, the value of IRD items is also included in the deceased partner's estate for estate tax purposes.[146] This means that the successor in interest and the estate both pay tax on the IRD amounts. Accordingly, the successor in interest is permitted to deduct the amount of estate tax paid on the IRD amounts to offset this double taxation of the IRD.[147]

BASIS OF A PARTNERSHIP INTEREST

Generally, the successor in interest's basis in the partnership interest acquired from the deceased partner is as follows.

	The FMV of the interest at the date of death (or alternative valuation date)[148]
+	Share of partnership liabilities assumed by the successor in interest
−	Value of any IRD items
	Successor in interest's basis in partnership interest

Basis generally does not include the value of an IRD item. Guaranteed payments and distributive shares of partnership income that are IRD are excluded from the successor's basis in the partnership interest received from the deceased partner. Only the payments for the decedent's interest in the partnership property constitute basis for the successor's interest.[149] Guaranteed payments or distributive shares of partnership income are taxed as received[150] and separately valued and included in the deceased partner's estate.[151]

Example 31. Tracy, Dale, and Kim are equal partners in their partnership business, TDK Interior Design. Their partnership agreement indicates that upon the death of a partner, the deceased partner's interest passes to Kim's sister Karen, who is named in the partnership agreement as the successor in interest. The partnership agreement further specifies that the partnership will pay the successor in interest $20,000 per year for four years. These payments are characterized as guaranteed payments by the partnership agreement.

Kim dies on June 30, 2013. The following amounts are from the balance sheet on Kim's date of death.

	Tax Basis	FMV
Cash	$30,000	$ 30,000
Unrealized cash receivables	0	75,000
Investments	9,000	21,000
Assets	$39,000	$126,000
Liabilities	$ 0	$ 36,000
Capital, Tracy	13,000	30,000
Capital, Dale	13,000	30,000
Capital, Kim	13,000	30,000
Liabilities and capital	$39,000	$126,000

145. IRC §691(a).

146. IRC §2031(a).

147. IRC §691(c).

148. Under estate taxation rules, an election may be made to use an alternate valuation date other than the date of death. See IRC §2032 and underlying regulations.

149. Treas. Reg. §1.742-1.

150. IRC §691(a).

151. IRC §§2031(a) , 691(c).

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Karen's basis in the partnership interest she receives is calculated as follows.

FMV of the interest at the date of death	$30,000
Share of liabilities assumed (1/3 of total liabilities)	12,000
Less: the value of IRD items (1/3 of unrealized cash receivables)	(25,000)
Basis to the successor in interest	$17,000

Note. The tax practitioner should consider an IRC §754 election at the partnership level so that Karen's inside basis equals her outside basis. This step up in basis would only apply to Karen.

INHERITING S CORPORATION STOCK

In many respects, the applicable rules that apply to the inheritance of S corporation shares from a deceased shareholder strongly resemble the comparable rules that apply to the inheritance of a partnership interest. However, there are some important areas in which the rules are very different.

Absent any estate planning to arrive at a different result, if the deceased shareholder leaves their S corporation ownership interest directly to one or more nonestate successors in interest, the value of the decedent's shares are included in the estate for estate tax purposes.

ALLOCATION OF INCOME IN THE YEAR OF DEATH

Each member of the S corporation is taxed on their respective pro-rata share of the S corporation's separately and nonseparately computed items of income, loss, deduction, and credit for the tax year.[152] Income is apportioned to the shareholders on a per-share, per-day basis.[153] The calculations in the following examples are done at the corporate level and are presented here for purposes of understanding the amounts reported on Schedule K-1.

Example 32. Lynn and Quinn respectively have a 60% and 40% ownership in LQ Library Services, Inc., an S corporation. The S corporation had $100,000 of long-term gain and $20,000 of §1231 gain from the sale of investments and assets in February 2013. In addition, $200,000 of income was received in November from the acquisition of a major contract with the local municipal library system. Each shareholder receives the following allocation of these items for 2013 as shown.

	Lynn (60%)	Quinn (40%)	Total
Separately stated items:			
Long-term gain	$ 60,000	$ 40,000	$100,000
§1231 gain	12,000	8,000	20,000
Total separately stated items	$ 72,000	$ 48,000	$120,000
Nonseparately stated income	120,000	80,000	200,000
Total allocation	$192,000	$128,000	$320,000

152. IRC §1366(a)(1).

153. IRC §1377(a)(1).

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Example 33. Use the same facts as **Example 32,** except Quinn dies on October 19, 2013. Lynn receives 60% of the gains and income for the year, while Quinn and his estate receive the remaining 40%. The initial calculations are the same as shown in the preceding table.

However, Quinn's death on October 19 means that his pro-rata share of the gain and income items, calculated on a per-share, per-day basis, will be reported for him as an individual for the portion of the year that he was alive (exactly 80% of the year).[154] Quinn's estate will report the remaining amount of the per-share, per-day gain and income items attributable to the latter 20% of the year.

Note. The actual date of death is included in the deceased shareholder's holding period for purposes of these calculations. The day following the date of death is the first date that the S corporation shares are treated as owned by the successor in interest.[155]

Accordingly, of the 40% allocated to Quinn and his estate collectively, 80% of that 40%, or 32% of the total (80% × 40%), will be reported on Quinn's personal return. Quinn's estate will report the remaining 20% of that 40% allocation (or 8% of the total). The allocation between Quinn and his estate follows.

	Quinn (80%)	Estate (20%)	Total
Separately stated items:			
Long-term gain	$ 32,000	$ 8,000	$ 40,000
§1231 gain	6,400	1,600	8,000
Total separately stated items	$ 38,400	$ 9,600	$ 48,000
Nonseparately stated income	64,000	16,000	80,000
Total allocation	$102,400	$25,600	$128,000

Observation. Using pro-rata allocations between shareholders using the per-share, per-day rule serves to average the income, gain, or loss items evenly throughout the year in a manner that makes the timing of the actual receipt of the income, gain, or loss items by the S corporation irrelevant to the shareholders who receive their respective pro-rata shares.

154. Treas. Reg. §1.1366-1(a)(1).

155. Treas. Reg. §1.1377-1(a)(2)(ii).

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Special Election

Shareholders may elect to use an interim closing method instead of using the per-share, per-day method of allocation when a shareholder dies. This election may provide the ability to take advantage of the time within a tax year that the S corporation actually received items of income, gain, or loss relative to the date on which the shareholder died.

Example 34. Use the same facts as **Example 33.** All the gain was received by the S corporation in February (before Quinn's death in October) and all of the income for the year was received in November (after Quinn's death). Quinn's tax advisor, after reviewing the relevant tax information relating to Quinn's final income tax return and estate tax return, determines that Quinn has substantial capital losses that could be used on his personal return for 2013 to offset capital gains. The tax advisor is also aware that the estate can claim some substantial deductions against any income that the estate must report. The tax advisor makes the special election to use the interim closing method. This divides the 2013 tax year into two short years. The first short year ends on Quinn's date of death (October 19); this is the period covered by Quinn's final income tax return. The second short tax year begins on October 20 and ends on December 31; this period is covered by a return for Quinn's estate (Form 1041, *U.S. Income Tax Return for Estates and Trusts)*.

	Quinn's Final Return	Estate Return	Total
Separately stated items:			
Long-term gain	$40,000	$ 0	$ 40,000
§1231 gain	8,000	0	8,000
Total separately stated items	$48,000	$ 0	$ 48,000
Nonseparately stated income	0	80,000	80,000
Total allocation	$48,000	$80,000	$128,000

By making the special election to use an interim closing, the tax advisor can report all S corporation gains that pass through to Quinn on Quinn's final income tax return (providing the ability to use Quinn's capital losses against that gain to the maximum extent) and can also report the income on the estate return (providing the ability to claim the anticipated estate deductions against that income).

Making the Election. This special election is made by the S corporation with the consent of all affected shareholders under Treas. Reg. §1.1377-1. This election is valid only when a shareholder's entire interest is disposed of.[156]

Observation. Although disposition of a shareholder's entire interest takes place at the death of the shareholder, this special election may also be used if a shareholder's entire interest is disposed of through gifting, share redemption, or in other ways.

[156] Treas. Reg. §1.1377-1(b)(1).

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The election is made by attaching a statement to a timely filed S corporation return (or amended return) for the year in which the shareholder died. The election must include the following information.[157]

- A declaration that the S corporation is making the special election under Treas. Reg. §§1.1377-1(a)(2) and (b)(5)(i) and is treating the tax year as two separate short tax years
- An indication that the shareholder's complete disposition of shares was due to the shareholder's death
- A statement by the S corporation that **each affected shareholder consents to the election** ("Affected shareholder" is defined as the shareholder who terminated their interest in the S corporation and all shareholders who are transferees of those shares during the tax year. If the shares disposed of are transferred to or redeemed by the corporation, all persons who are shareholders during the year are affected shareholders.[158])
- The signature of an authorized officer of the S corporation to verify that the requirements for making the election have been met

Observation. Under partnership taxation rules, the default method used upon the death of a partner is the interim closing. However, partners may agree on another reasonable method. If the partners agree to another reasonable method, no election is necessary. Partners might agree on using a method for the partnership that approaches the same result that the S corporation per-share, per-day rule provides.

BASIS OF AN S CORPORATION INTEREST

Generally, a successor in interest has a stock basis equal to the stock's FMV at the date of death.[159] The date-of-death FMV is reduced by the amount of any IRD attributable to the deceased shareholder.[160]

Observation. There is no provision under the S corporation rules to adjust the "inside basis" of a corporation's assets in a manner similar to an IRC §754 election for partnership assets. Accordingly, if an S corporation disposes of an asset shortly after a shareholder's death occurs, the successor in interest must report their pro-rata share of gain or loss in connection with the asset disposition.

157. Treas. Reg. §1.1377-1(b)(5)(i).

158. Treas. Reg. §1.1377-1(a)(2)(B).

159. IRC §1014.

160. IRC §1367(b)(4)(B).

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INTERNATIONAL TAXATION: OFFSHORE ASSET REPORTING

Note. See **www.irs.gov/Businesses/International-Business/** for additional information on international taxation.

The IRS has recently focused substantial attention and resources on ensuring offshore asset reporting compliance. There are two filing requirements that tax practitioners must be aware of.

- Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (the "FBAR" form)
- Form 8938, *Statement of Specified Foreign Financial Assets*

Each of these two forms has its own filing requirements and filing obligations for affected taxpayers. A taxpayer may be obligated to file one or both of these forms. Some taxpayers, depending on their own particular situation relating to offshore assets, may have no filing requirements. It is of the utmost importance for tax practitioners to be aware of the factors that trigger a requirement to file each of these forms because of the substantial civil and criminal penalties for failure to file.

Observation. Some tax practitioners may need to begin asking clients questions about the existence and nature of assets owned outside the United States to fulfill the Circular 230 due diligence requirement imposed on tax practitioners.

FBAR FILING REQUIREMENTS

An FBAR filing requirement may be indicated by the taxpayer's answers on Part III of Schedule B, *Interest and Ordinary Dividends,* which may accompany the taxpayer's Form 1040.

on that form.

Note. If line 6 is over $1,500, you must complete Part III.

			Yes	No
Part III Foreign Accounts and Trusts (See instructions on back.)		You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.		
	7a	At any time during 2012, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
		If "Yes," are you required to file Form TD F 90-22.1 to report that financial interest or signature authority? See Form TD F 90-22.1 and its instructions for filing requirements and exceptions to those requirements		
	b	If you are required to file Form TD F 90-22.1, enter the name of the foreign country where the financial account is located ▶		
	8	During 2012, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 17146N **Schedule B (Form 1040A or 1040) 2012**

Part III of Schedule B requires some basic disclosure by the taxpayer with respect to any financial interest in (or signature authority over) a foreign financial account. For taxpayers required to answer affirmatively to question 7a in Part III, the tax return preparer must look into the following additional filing requirements to determine whether the taxpayer must file an FBAR form.

Generally, a **"United States person"** who has a **financial interest** in or **signature or other authority** over one or more **foreign financial accounts** must file an FBAR form if the aggregate value of the foreign financial account or accounts exceeds $10,000 at any time during the calendar year.

The term **"United States person"** includes U.S. citizens and residents. It also includes entities — such as trusts, estates, corporations, partnerships, or LLCs — created or organized under U.S. law.[161]

[161] 31 CFR §1010.350(b); see also IRS Ann. 2010-16, 2010-1 CB 450 (for 2009 and earlier calendar years).

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A United States person has a **financial interest** in a foreign financial account if:[162]

1. The United States person owns the foreign financial account (even if the account is held for the benefit of another U.S. or foreign person);
2. A person owns the foreign financial account and acts as agent, nominee, or attorney, or otherwise acts on behalf of the U.S. person;
3. The owner of the foreign financial account is a corporation or partnership in which the United States person directly or indirectly owns more than 50% of either the total share value or voting power (or more than a 50% interest in either the partnership profits or partnership capital); or
4. The owner of the foreign financial account is a trust in which the United States person has a present beneficial interest in more than 50% of the assets (or from which the United States person receives more than 50% of the income).

> **Note.** If a United States person has an ownership interest in an entity while that entity is the owner of a foreign financial account, the tax practitioner must determine whether the entity is subject to the FBAR rules. For further details on other entities subject to the FBAR rules, see 31 CFR §1010.350(e)(2).

Signature or other authority means the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds, or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained.[163]

> **Note.** Some individuals who have signature authority over, but no financial interest in, a foreign financial account are not subject to the FBAR rules.[164] For further details on those United States persons with signature authority who may be exempt, see 31 CFR §1010.350(f)(2).

Foreign financial account generally refers to a **reportable account** located outside the geographical boundaries of the United States.[165]

> **Note.** For the purposes of FBAR, the geographical boundaries of the United States includes U.S. territories and possessions.[166]

Many types of accounts are **reportable accounts,** including the following.[167]

- Bank accounts
- Securities accounts and accounts with a broker or dealer that trades in options in any commodity
- An account with a deposit-taking financial institution
- An insurance or annuity policy with a cash value
- A mutual or other pooled fund investment if shares are offered to the general public and there is a regular net asset value determination and regular redemptions

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162. 31 CFR §1010.350(e).
163. 31 CFR §1010.350(f)(1).
164. 31 CFR §1010.350(f)(2).
165. 31 CFR §1010.350(d).
166. 31 CFR §1010.350(d); 31 CFR §1010.100(hhh).
167. 31 CFR §1010.350(c).

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Some accounts are not reportable accounts. An account belonging to the United States or a state or state agency is not a reportable account. In addition, an account with a military banking facility operated by a U.S. financial institution is not a reportable account.[168]

> **Note.** Further guidance on reportable accounts and exceptions may be found at 31 CFR §1010.350(c).

Account Valuation and Reporting

The FBAR filing requirement is triggered if the aggregate value of the foreign financial account(s) exceeds $10,000 at any time during the calendar year. Periodic account statements may be relied on to determine the maximum value of the account, provided that the statements fairly reflect the maximum account value during the calendar year.[169] Periodic statements that provide the value in the account at the end of the statement period may be relied on for this purpose if they are bona fide statements prepared in the ordinary course of business.[170]

> **Note.** Use of an end-of-period value is at odds with a filing requirement that is triggered when the aggregate value exceeds $10,000 "at any time during the year." Further guidance is needed with respect to the valuation of accounts to ensure clear compliance with the FBAR filing rules.

Multiple Accounts. Multiple reportable accounts are reported in a single FBAR filing for the year. Special rules exist to simplify reporting for United States persons with more than 25 reportable accounts. These special rules are summarized as follows.

- If the filer has a financial interest in 25 or more foreign accounts, the filer is only required to provide the actual number of accounts and other basic information on the FBAR form.
- If the filer has only signature authority over 25 or more accounts but no financial interest in those accounts, the filer must generally provide the actual number of accounts and other basic information and also disclose information regarding the persons who have financial interest in the accounts. This is to ensure that law enforcement agencies receive meaningful information about persons who have actual financial interests in the accounts disclosed in the FBAR form.[171]

In both of these cases, the filer must retain detailed account-specific records that can be made available upon the request of the Treasury Department.

Joint Accounts. Generally, if joint accounts are the subject of FBAR reporting, the spouse who is required to file the FBAR form must disclose the full value of the jointly held reportable accounts.[172] However, the spouse of an FBAR filer is not required to file a separate FBAR form if **all** of the following conditions are met.

- All of the accounts that the nonfiling spouse is required to report are jointly owned with the filer spouse.
- The filing spouse reports all of the jointly owned accounts on a timely filed FBAR form.
- Both spouses sign the FBAR form filed for the year.[173]

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168. 31 CFR §1010.350(c)(4).
169. See the instructions to Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*.
170. Federal Register, Vol. 76, No. 37 (Feb. 24, 2011).
171. Ibid.
172. See the instructions to Form TD F 90-22.1.
173. Ibid.

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New Electronic Filing Requirement

The FBAR form is not filed with a tax return. **Beginning July 1, 2013,** FBARs **must be filed electronically** using the Financial Crimes Enforcement Network's (FinCEN) Bank Secrecy Act (BSA) e-filing system. This filing system may be accessed at **http://bsaefiling.fincen.treas.gov/main.html.**

> **Note.** The online filing system currently allows for only **one** digital signature. If joint accounts are the subject of the filing requirement, this limitation may require a spouse to file a separate FBAR form when that spouse would otherwise not be required to file.

> **Observation.** If the individual is unable to electronically file an FBAR form because of a lack of Internet access, FinCEN guidance indicates that the individual should contact FinCEN's regulatory helpline at 1-800-949-2732 to discuss alternative filing arrangements.[174]

Filing Due Date

Generally, the filing due date is June 30 of the year following the calendar year for which the form is filed.[175] If an FBAR form is filed late, an explanatory statement should be attached.[176]

Certain officers or employees of various types of entities have special extended deadlines that may apply to their situations if they have signature authority over one or more entity accounts but do not have any financial interest in those accounts.

> **Note.** For further details on these special extended deadlines and when they apply, see FinCEN Notices 2012-1[177] and 2012-2.[178]

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174. *Administrative Difficulties in Submitting Electronic Reports to FinCEN*. Jun. 24, 2013. FinCEN. [www.fincen.gov/statutes_regs/guidance/html/FIN-2013-G002.html] Accessed on Jul. 3, 2013.

175. See the instructions to Form TD F 90-22.1.

176. Ibid.

177. *FinCEN Notice 2012-1 FBAR Filing Requirement*. Feb. 14, 2012. FinCEN. [www.fincen.gov/statutes_regs/guidance/pdf/FinCEN_Notice_2012-1_FBAR_Filing_Extension.pdf] Accessed on Jul. 3, 2013.

178. *FinCEN Notice 2012-2 FBAR Filing Requirement*. Dec. 26, 2012. FinCEN. [www.fincen.gov/statutes_regs/guidance/pdf/FinCEN_Notice_2012-2_FBAR_Filing_Extension.pdf] Accessed on Jul. 3, 2013.

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FBAR Penalties

Civil and/or criminal penalties may be assessed for violations of the statute[179] that requires the filing of the FBAR form and the disclosure of all the taxpayer's reportable accounts on the form. Generally, the penalties may be summarized as follows.

- Civil penalties up to a maximum of $10,000 per violation may be imposed unless reasonable cause exists for the violation.[180]
- Willful failure to report an account or an account's identifying information may result in a penalty that is the greater of $100,000 or half of the balance of the account at the time the violation occurred.[181]
- A criminal penalty of up to $250,000 or five years imprisonment or both may be imposed. However, if a pattern of illegal activity is discovered, the criminal penalty may be up to $500,000, 10 years imprisonment, or both.[182]
- Civil and criminal penalties may both be imposed for the same violation.[183]

Note. For further information on the applicable civil and criminal penalties, see 31 USC §§5321 (civil penalties) and 5322 (criminal penalties). Further guidance on penalties and other aspects of filing the FBAR form may be found at **www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Report-of-Foreign-Bank-and-Financial-Accounts-(FBAR).**

FORM 8938 FILING REQUIREMENTS

On March 18, 2010, Congress passed the Foreign Account Tax Compliance Act (FATCA).[184]

Under FATCA, **specified individuals** with **specified foreign financial assets** that exceed certain **value thresholds** must report those assets to the IRS as part of their income tax return.[185] This report must be made on Form 8938, *Statement of Specified Foreign Financial Assets*.

A **specified individual** is either:

- A U.S. citizen or lawful resident of the United States,
- A nonresident alien spouse who elects to be treated as a resident alien for tax purposes, or
- A nonresident alien who resides in Puerto Rico or American Samoa.

Note. Proposed regulations were issued on December 19, 2011, regarding a Form 8938 filing requirement for specified entities that have specified foreign financial assets. Although the comment period for these proposed regulations closed March 19, 2012, the regulations have not yet been made effective by the IRS. However, the IRS anticipates issuing final regulations on this subject.[186]

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179. 31 CFR §1010.350.

180. Instructions to Form TD F 90-22.1.

181. Ibid.

182. 31 USC §5322.

183. 31 USC §5321(d).

184. PL 111–147 (2010).

185. IRC §6038D(a).

186. *Information for U.S. Taxpayers on Form 8938 Requirements*. Apr. 3, 2013. [www.irs.gov/Businesses/Corporations/InformationforUSTaxpayers] Accessed on Jul. 8, 2013.

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Generally, a **specified foreign financial asset** includes the following.[187]

- Any financial account maintained by a foreign financial institution
- A foreign financial account held for investment purposes but not held with a foreign financial institution (such as a non-U.S. stock or other security or an interest in a foreign entity)

A financial instrument or a contract with a non-U.S. counterparty or issuer may constitute a specified foreign financial asset.[188] An interest in a pension plan or deferred compensation plan in connection with a foreign employer is also a specified foreign financial asset.[189]

Observation. Specified foreign financial assets are defined in Temp. Treas. Reg. §1.6038D-3T. However, there is frequently uncertainty about what assets are included in the definition. Tax practitioners should become familiar with this regulation. Additional guidance is available in the instructions to Form 8938.

The following items are examples of foreign interests that are **not** considered to be specified foreign financial assets.

- An interest in a foreign entity, such as a partnership, that is used in connection with a trade or business and therefore not held for investment purposes
- An account maintained by a U.S. financial institution
- An interest in the social security, social insurance, or other similar program of a foreign country

Value Thresholds

A filing requirement is triggered for taxpayers with specified foreign financial assets that, in the aggregate, exceed the values specified below for their filing status and residency.

Filing Status	Living in the United States	Living Abroad
Single and MFS	More than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year	More than $200,000 on the last day of the tax year or more than $300,000 at any time during the tax year
MFJ	More than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year	More than $400,000 on the last day of the tax year or more than $600,000 at any time during the tax year

Observation. The filing threshold amounts in the above table are not subject to an inflation adjustment. This may trigger a filing requirement in a later year for a client who has no present filing requirement. However, the regulation that specifies the preceding filing thresholds expires December 12, 2014,[190] after which a new regulation with updated amounts may become effective.

187. Temp. Treas. Reg. §1.6038D-3T.

188. Ibid.

189. Form 8938 instructions.

190. Temp. Treas. Reg. §1.6038D-2T(f).

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Spouses who file MFJ generally file one joint Form 8938. To determine whether their specified foreign financial assets have a value over the applicable threshold for the filing requirement, MFJ filers count the value of all jointly owned assets only once.

Note. If there is joint ownership of a specified foreign financial asset with someone who is **not** a spouse, **each** joint owner counts the **full value** of the asset in order to determine whether they are required to file a Form 8938.

For MFS filers, each spouse only counts half of the value of any jointly owned specified foreign financial asset in making the filing requirement determination.[191]

Valuation of Specified Foreign Financial Assets

Generally, guidance[192] with respect to the valuation of specified foreign financial assets indicates that fair market value is used for Form 8938 reporting purposes. Valuation rules require the value of the asset to be expressed in U.S. dollars. This is done by converting the currency in which the asset is denominated to U.S. dollars on December 31 of the tax year (even if the taxpayer disposed of the asset earlier in the year).[193] In order to ascertain the maximum value an asset attained during the year, the taxpayer can rely on periodic statements unless the taxpayer has actual knowledge or reason to know (based on readily accessible information) that the statements do not reflect a reasonable estimate of the asset's maximum value during the year.[194]

Note. Further guidance on the valuation rules and the valuation approach taken with various types of assets (such as foreign pension plans) can be found in the Form 8938 instructions and in Temp. Treas. Reg. §1.6038D-5T.

Form 8938 Penalties

Failure to timely file Form 8938 may result in a $10,000 penalty. If the IRS issues a failure-to-file notice to the taxpayer and the taxpayer fails to file the form within 90 days, an additional $10,000 penalty may be assessed for each 30-day (or part of a 30-day) period after the expiration of the 90-day grace period, up to a maximum of $50,000.[195]

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191. Form 8938 instructions.
192. Temp. Treas. Reg. §1.6038D-5T.
193. Temp. Treas. Reg. §1.6038D-5T(c)(4).
194. Temp. Treas. Reg. §1.6038D-5T(d).
195. Form 8938 instructions.

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2013 Workbook

APPENDIX: COMPARISON OF FORM 8938 AND FBAR[196]

	Form 8938	FBAR
Who must file?	Specified individuals, which include U.S. citizens, resident aliens, and certain non-resident aliens that have an interest in specified foreign financial assets and meet the reporting threshold	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold
Does the United States include U.S. territories?	No	Yes, resident aliens of U.S. territories and U.S. territory entities are subject to FBAR reporting
Reporting threshold (total value of assets)	$50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad)	$10,000 at any time during the calendar year
When do you have an interest in an account or asset?	If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return	**Financial interest:** You are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title. **Signature authority:** You have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account. See instructions for further details.
What is reported?	Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign nonaccount investment assets	Maximum value of financial accounts maintained by a financial institution physically located in a foreign country
How are maximum account or asset values determined and reported?	Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars.	Use periodic account statements to determine the maximum value in the currency of the account. Convert to U.S. dollars using the end of the calendar year exchange rate and report in U.S. dollars.
When due?	By due date, including extension, if any, for income tax return	Received by June 30 (no extensions of time granted)

[196] *Comparison of Form 8938 and FBAR Requirements.* Feb. 25, 2013. [www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements] Accessed on Aug. 14, 2013.

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	Form 8938	FBAR
Where to file?	File with income tax return according to instructions for filing the return.	Mail to: Department of the Treasury Post Office Box 32621 Detroit, MI 48232-0621 For express mail to: IRS Enterprise Computing Center ATTN: CTR Operations Mailroom, 4th Floor 985 Michigan Avenue Detroit, MI 48226 Certain individuals may file electronically at BSA E-Filing System
Penalties	Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of non-filing after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply	If non-willful, up to $10,000; if willful, up to the greater of $100,000 or 50 percent of account balances; criminal penalties may also apply.

Types of Foreign Assets and Whether They Are Reportable

	Form 8938	FBAR
Financial (deposit and custodial) accounts held at foreign financial institutions	Yes	Yes
Financial account held at a foreign branch of a U.S. financial institution	No	Yes
Financial account held at a U.S. branch of a foreign financial institution	No	No
Foreign financial account for which you have signature authority	No, unless you otherwise have an interest in the account as described above	Yes, subject to exceptions
Foreign stock or securities held in a financial account at a foreign financial institution	The account itself is subject to reporting, but the contents of the account do not have to be separately reported	The account itself is subject to reporting, but the contents of the account do not have to be separately reported
Foreign stock or securities not held in a financial account	Yes	No
Foreign partnership interests	Yes	No

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Types of Foreign Assets and Whether They Are Reportable *(continued)*

	Form 8938	FBAR
Indirect interests in foreign financial assets through an entity	No	Yes, if sufficient ownership or beneficial interest (i.e., a greater than 50 percent interest) in the entity. See instructions for further detail.
Foreign mutual funds	Yes	Yes
Domestic mutual fund investing in foreign stocks and securities	No	No
Foreign accounts and foreign non-account investment assets held by foreign or domestic grantor trust for which you are the grantor	Yes, as to both foreign accounts and foreign nonaccount investment assets	Yes, as to foreign accounts
Foreign-issued life insurance or annuity contract with a cash-value	Yes	Yes
Foreign hedge funds and foreign private equity funds	Yes	No
Foreign real estate held directly	No	No
Foreign real estate held through a foreign entity	No, but the foreign entity itself is a specified foreign financial asset and its maximum value includes the value of the real estate	No
Foreign currency held directly	No	No
Precious metals held directly	No	No
Personal property, held directly, such as art, antiques, jewelry, cars and other collectibles	No	No
Social Security type program benefits provided by a foreign government	No	No

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