Chapter 4: Tax Considerations in the Distribution of Estate Assets

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Note. Corrections were made to this workbook through January of 2023. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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ESTATE TAX

For most individuals, the federal estate tax is no longer a real concern. For example, IRS Statistics of Income reports that in 2016 there were only 5,467 taxable estate returns filed for 2,700,727 adult deaths — far less than 1%.[1] In that year, the basic exclusion amount was $5.45 million[2] as compared to $12.06 million[3] in 2022. Therefore, the focus for most estate planning is likely to be on income tax savings resulting from the IRC §1014 fair market value (FMV) basis of property acquired from a decedent. This is commonly referred to as **stepped-up basis** because of the assumption that property in the hands of a decedent will generally have appreciated in value, although the basis is stepped down for property that has depreciated in value. This chapter covers some of the more common and important basis rules affecting property distributed from a decedent.

The **exclusion amount** is the maximum value of the taxable estate that can pass free of the estate tax. It is based on the applicable credit amount allowed against the estate tax under IRC §2010. After the enactment of the portability election in 2011, there are two exclusion amounts: the basic exclusion amount and the applicable exclusion amount. The **basic exclusion amount** is the amount allowed to the estate of a decedent. The **applicable exclusion amount** is the sum of the basic exclusion amount for a decedent plus the deceased spouse unused exclusion (DSUE) amount if a portability election was made by a surviving spouse.[4]

Observation. Estate or inheritance tax planning may still be necessary for purposes of state law. At the time these materials were prepared, 17 states plus the District of Columbia had estate or inheritance taxes.[5] States vary in their exemption amounts, only a few recognize portability elections, and many do not recognize a qualified terminable interest property (QTIP) election (explained later in this chapter), although some permit a separate state QTIP election.[6]

The difference between an estate tax and an inheritance tax is who pays the tax. An estate tax is levied on and payable by the decedent's estate before distribution to beneficiaries; an inheritance tax is not imposed on a decedent's estate, but on the heirs of the decedent who take (versus disclaim) property. Discussion of state estate and inheritance laws is beyond the scope of these materials.

Note. This chapter does not address rules that might apply in community property states, unless noted.

1. *SOI Tax Stats — Historical Table 17*. Mar. 7, 2022. IRS. [www.irs.gov/statistics/soi-tax-stats-historical-table-17] Accessed on Jun. 24, 2022.
2. Rev. Proc. 2015-53, 2015-44 IRB 615.
3. Rev. Proc. 2021-45, 2021-48 IRB 764.
4. IRC §2010(c).
5. *18 States With Scary Death Taxes.* Block, Sandra, Mengle, Rocky, and Niedt, Bob. Feb. 23, 2022. Kiplinger. [www.kiplinger.com/retirement/inheritance/601551/states-with-scary-death-taxes] Accessed on Mar. 8, 2022.
6. See *State Death Tax Chart*. The American College of Trust and Estate Counsel. Revised Jan. 1, 2022. [www.actec.org/resources/state-death-tax-chart/] Accessed on Feb. 20, 2022.

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BASIS OF PROPERTY FROM A DECEDENT

IRC §1014 generally provides that the basis of property acquired from a decedent is the FMV of the property on the decedent's date of death. To be eligible for §1014 FMV basis, the property must be considered to have been acquired from, or to have passed from a decedent in, among others, the following manners.

- Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent[7]
- Property transferred by the decedent in trust during life, to pay the income to the decedent or to someone else at the decedent's direction, and with the decedent's right at all times up to death to revoke the trust or to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust[8]
- A surviving spouse's half share of community property held by the deceased spouse and the surviving spouse under any U.S. state or foreign country's community property law if at least half of the entire community property interest in the property was includable in the gross estate of the deceased spouse[9]

Practitioner Planning Tip

There are nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Married couples in Alaska, Tennessee, and South Dakota can sign an agreement to elect to treat their assets and debts as community property; otherwise, the common law rules apply. A married couple moving from a community property state to a common law state generally does not change the nature of their property that was acquired as community property in the former state. It is therefore important on the death of a first spouse to determine whether the couple ever lived in a community property state and may still have community property assets. Practitioners may want to reference IRS Pub. 555, *Community Property,* for general guidance on the income tax treatment of such property.

- QTIP includable in the gross estate of the decedent under IRC §2044[10]
- Property acquired from the decedent by reason of death, form of ownership, or other conditions, including exercise of power of appointment, if the property is required to be included in the gross estate of the decedent[11]

Observation. Generally, if an item is required to be included in a decedent's gross estate and is not subject to a special basis rule, the item receives a basis equal to its FMV on the decedent's date of death.[12] It is therefore important to understand what is required to be included in the gross estate and tools that can help achieve increased opportunities for stepped up basis. Some of these will be described in this chapter.

7. IRC §1014(b)(1).
8. IRC §1014(b)(2) and (3).
9. IRC §1014(b)(6).
10. IRC §1014(b)(10).
11. IRC §1014(b)(9) and Rev. Rul. 56-215, 1956-1 CB 324.
12. Rev. Rul. 56-215, 1956-1 CB 324.

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The following items are subject to special basis rules.

- Income in respect of a decedent (IRD) under IRC §691 carries the same basis and character (ordinary, capital gain, tax-exempt, etc.) it had in the hands of the decedent.[13]
- Property subject to the alternate valuation date under IRC §2032 or alternate valuation under IRC §2032A takes as its basis the value used for those purposes.
- Appreciated property gifted to the decedent within one year preceding death and that passes back to the donor of the property, or to the donor's spouse after the decedent's death, has the same adjusted basis it had in the hands of the decedent immediately before death.[14]

Caution. IRC §2032 allows the executor of a decedent's estate to elect to value the gross estate on the date that is the earlier of six months after the decedent's death or the date the property is distributed, sold, exchanged, or otherwise disposed. The election is available **only** if its effect is to decrease both the value of the gross estate and the estate and generation-skipping transfer trust (GSTT) taxes are actually payable by the estate.[15] Thus, the alternate valuation date cannot be used as a means to increase the basis in assets that have appreciated during that 6-month period.

VALUATION DISCOUNTS AND GIFTS

Gifting is a common estate planning tool for removing assets from an estate to avoid a potential estate tax issue. Gifts are valued at FMV for gift tax purposes.[16] To the extent gifts exceed the annual gift tax exclusion, they are taxable.[17] No gift tax is payable, however, if an individual's cumulative taxable gifts do not exceed the individual's basic exclusion amount.[18] Making taxable gifts uses up basic exclusion amounts that might otherwise be used against the estate tax.

Valuation discounts can be used to leverage a gifting strategy. For example, a gift of an undivided ownership interest in real estate to someone as a tenant in common might be subject to a 10 to 20% lack of marketability discount.[19] A closely held corporation could be subject to discounts for both lack of marketability and minority interests.[20] Family limited partnerships have been popular for their high marketability and minority discounts.[21]

Not only is the value of the gift subject to discount, but the interest that the donor retains generally is also subject to discount. This is where a problem arises. The gifted property has a carryover basis, so the gift tax valuation discount generally has no effect on the donees of the gift.[22] Any fractional interest retained by the donor that is includable in their gross estate, however, will be subject to an appropriate valuation discount, just as the gifted interests were.[23] Fractional interests in real estate, for example, are at a minimum generally subject to lack of marketability discounts based on the costs of partition but may be higher due to other factors.[24]

Note. Unlike community property or tenancies in common, **property held as joint tenants with right of survivorship or tenants by the entirety is not subject to discount with respect to the fractional interest attributable to the deceased tenant.[25]**

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13. IRC §1014(c).
14. IRC §1014(e).
15. IRC §2032(c).
16. IRC §2512.
17. IRC §2503(b).
18. Treas. Reg. §25.2501-1.
19. For example, see *LeFrak v. Comm'r,* 66 TC Memo 1297 (1993).
20. For example, see *Kosman v. Comm'r,* TC Memo 1996-112 (Mar. 11, 1996).
21. For example, see *Peracchio v. Comm'r,* TC Memo 2003-280 (Sep. 25, 2003).
22. IRC §1015.
23. For example, see *Estate of Pillsbury v. Comm'r,* TC Memo 1992-425 (Jul. 27, 1992).
24. For example, see *Estate of Stevens v. Comm'r,* TC Memo 2000-53 (Feb. 18, 2000).
25. *Estate of Young v. Comm'r,* 110 TC 297 (1998).

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GROSS ESTATE

The Code contains several provisions describing assets with specific attributes that are includable in the gross estate. The following materials briefly describe the most important of these. IRC §2034, dealing with dower or curtesy interests, is omitted.[26]

IRC §2033: PROPERTY IN WHICH DECEDENT HAD AN INTEREST

The reach of §2033 is broad. It includes "the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death."[27] There are two conditions that must be satisfied for property to be included in the gross estate under §2033. **First,** the decedent must have had a beneficial interest in the property and, **second,** the interest must have been held at death and pass to another as a result of death.[28] If a property interest terminates at death there can be no inclusion under §2033, although other provisions may operate to bring it into the gross estate.[29] Thus, because an income beneficiary's right to receive distribution of trust corpus on termination of the trust at a specified point in time was contingent on their surviving until that time, their contingent remainder interest was not included in their gross estate when they died prior to termination of the trust.[30]

Example 1. Alice dies and has property subject to probate. All the probate property is included in her gross estate under §2033.

Example 2. Benji transfers property to an irrevocable trust of which he is the life income beneficiary, with the remainder interest transferred at his death to his children. Because Benji's entire interest in the property terminates at his death, there is no inclusion of the property in his gross estate under §2033. However, IRC §2036 (discussed later) causes inclusion because Benji made a transfer of property in which he retained the right to income.

The requirement that the decedent must have had a beneficial interest in the property means the decedent must have been able to benefit directly from the property itself. There are many cases, for example, in which the issue was whether a decedent had made a completed gift prior to death to have no beneficial interest in the property at death for purposes of §2033.[31] It is also necessary to distinguish circumstances where a decedent may have had an interest in property but received no benefit from that interest.

For example, the trustee of a trust may hold legal title to trust assets. Under state law, this is clearly an interest in property. The trustee receives no benefit from that legal title because the trustee holds title solely to enable it to manage the property for the benefit of the beneficiary and for the protection of the remainder beneficiaries. In a sense, the trustee may benefit from the performance of its services in the form of a trustee's fee, but that is from services performed and not because of ownership of a beneficial interest in the property itself. Because the trustee owns nothing of benefit in the property, it is improper to include the value of the trust assets in the gross estate of the trustee. However, when a trustee holds trust assets that were improperly distributed to the trustee, the assets constitute an includable interest at the time of the trustee's death under §2033.[32]

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26. Dower or curtesy interests are antiquated laws giving surviving wives (dower) and husbands (curtesy) certain surviving rights in a deceased spouse's property. Presently, these rights to claim a share of a deceased spouse's estate are gender-neutral and state specific (e.g., elective share, exempt property, family allowance).

27. Treas. Reg. §20.2033-1(a).

28. For example, see *U.S. v. Land*, 303 F.2d 170 (5th Cir. 1962).

29. Rev. Rul. 67-370, 1967-2 CB 324.

30. *Nodine v. Comm'r*, 62 TC 400 (1974).

31. For example, see *Rose v. Comm'r,* 65 F.2d 616 (6th Cir. 1933) where gifts of partnership interests to family members were completed gifts under the predecessor to §2033 (even though oral) because of acquiescence of the donee partners, proper treatment on partnership books to reflect the transfer, and subsequent confirmation in writing.

32. *Estate of Hester v. U.S.,* No. 5:06-cv-00041-sgw-jgw (W.D. Va. March 2, 2007), *aff'd per curium*, 297 Fed. Appx 276 (4th Cir. 2008).

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IRC §2035: ADJUSTMENTS FOR GIFTS WITHIN THREE YEARS OF DEATH

Prior to the Tax Reform Act of 1976[33] (TRA), §2035 required the gross estate to include the value of any interest in property transferred by the decedent within three years before death if the transfer was in contemplation of death and was not for full and adequate consideration. The TRA changed the rule by requiring the value of **all** property transferred within three years at death to be included in the gross estate. Congress felt this would eliminate the considerable litigation concerning the motives of decedents in making gifts. Five years later, Congress changed its mind again, and in the Economic Recovery Tax Act of 1981[34] enacted legislation excluding most gifts made within three years of death from the gross estate.

For individuals dying today, the gross estate generally does not include the value of any property transferred prior to death even if the transfer is made in actual contemplation of death. There are **four exceptions if within three years of death,** an individual transfers or releases an interest in property described in the following Code sections, the value of the transferred property interest is included under §2035 to the extent it would have been included under the other provision (less any consideration paid).

1. IRC §2036 (retained interest)
2. IRC §2037 (transfers taking effect at death)
3. IRC §2038 (revocable transfers)
4. IRC §2042 (life insurance)

Example 3. Ashley transfers Blackacre to Bill but retains a life estate in Blackacre. Within three years of death, Ashley also conveys the life estate to Bill, meaning Ashley no longer possesses any interest in Blackacre at death. Because Blackacre would have been includable in Ashley's gross estate under §2036 if she had kept the life estate until death, Ashley's relinquishment of the life estate within three years of death is caught by §2035, meaning the value of the entire property must be included in Ashley's gross estate and may therefore have a FMV basis under §1014 (stepped-up basis) as of Ashley's date of death.

Example 4. Carmen owns a $1 million life insurance policy on her life. If she owns the policy at death, it is includable in her gross estate under §2042. She therefore creates an irrevocable life insurance trust and transfers all incidents of her ownership in the insurance policy to the trust. If Carmen dies within three years from the date of transfer, the entire $1 million death benefit is includable in her gross estate under §2035. If she lives beyond three years, none of the death benefit is includable in her gross estate.

Note. If there is an estate tax liability and the estate is utilizing IRC §303(b) relating to distributions in redemption of stock to pay death taxes or §2032A relating to special valuation of certain farms and real property, all transfers within three years of death must be considered in determining **eligibility** for those provisions. In addition, in determining eligibility for installment payments of estate tax under IRC §6166, the 35% of adjusted gross estate requirement must be satisfied **both** with and without the application of §2035.

IRC §2035(e) excludes any transfer by gift (other than a transfer with respect to a life insurance policy) if a gift tax return is not required to be filed solely because the value of the gift is within the gift tax annual exclusion under §2503(b) or is excluded from gift tax under §2503(e) because it is made directly to an educational organization or medical care provider on behalf of a donee. Transfers to a spouse that qualify for the gift tax marital deduction are not within this exclusion, however.[35]

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33. *Tax Reform Act of 1976,* PL 94-455.

34. *Economic Recovery Tax Act of 1981,* PL 97-34.

35. IRC §2035(c)(3).

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IRC §2036: TRANSFERS WITH RETAINED LIFE ESTATE

Observation. IRC §§2036, 2037, and 2038 are often referred to as **string transfers.** These are transfers of property interests made during life, but the transferor has retained until death some interest or power (a string) that Congress determined as a policy matter should require inclusion in the transferor's gross estate.[36]

The problem addressed by §2036 is that of an individual who transfers property during life, but who retains either some beneficial interest in the property or the right to determine the persons who will enjoy the beneficial interest. If the interest retained by the individual ends at death, such as a life estate, §2033 will not apply because that provision requires that there be some form of transfer of the property interest at death from the decedent to someone else. This does not happen with a life estate because the life interest of the decedent simply expires, leaving the remainder beneficiary with full beneficial ownership of the property. If not for §2036, therefore, the estate tax could be largely avoided by such maneuvers as conveying a remainder interest in property while retaining the beneficial interest for life.

Example 5. Amos irrevocably conveys Blackacre to his children but reserves a life estate for himself. The remainder interest in Blackacre is now owned by the children subject to Amos' right to the use and benefit from the property during his life. At Amos' death, his life estate terminates, and the remainder beneficiaries automatically are entitled to the use and benefit of the property from that point forward. Thus, there is no transfer of an interest in property from Amos to his children at his death because the transfer of the remainder interest carried with it the right to the future use and benefit of the property by the children effective at the instant of Amos' death. IRC §2033 would therefore not operate to bring the value of the property into Amos' gross estate even though, as a practical matter, he continued to enjoy the full benefit of the property until his death.

Observation. In property law terms, after the conveyance, Amos owns the **present interest** in the property, which is the present right to the use and benefit of the property. His children actually own the property subject to Amos' right to possession and use during his life (his **life estate**). This ownership interest is called a **remainder,** in a sense because the children own everything about the property that remains after Amos' death. The right of the children to possession and use of the property in the future is referred to as a **future interest.** (Note that there can be a future interest that is not also a remainder, such as a GSTT to Amos' children for their lives, remainder to his grandchildren.) The future interest automatically becomes a present interest upon Amos' death. Thus, there is no conveyance when Amos dies.

IRC §2036 has **three conditions that must be satisfied** before it applies.

1. The decedent must have transferred an interest in property for less than full consideration.
2. The decedent must have retained possession, enjoyment, or the income right from the property or a right somehow to designate the person who will have those interests.
3. The retention must have been for the decedent's life, for a period not ascertainable without reference to the decedent's death, or in fact not ending before the decedent's death.[37]

[36] For example, see *Trust Company of Georgia v. Allen,* 164 F.2d 438 (5th Cir. 1947), *cert. denied*, 333 U.S. 856 (1948).

[37] Treas. Reg. §20.2036-1(a).

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Example 6. Auggie deeds real estate as a gift to his daughter, Barbara, but retains the right to the use of the property for the rest of his life. Auggie has kept a life estate and Barbara is the remainder beneficiary. Barbara is effectively the owner of the property while Auggie is alive but is not entitled to the use of the property because Auggie owns the right to use it so long as he lives (the present interest). Upon Auggie's death, his right to use the property dies with him and Barbara automatically becomes entitled to the use of the property.

The transfer by Auggie is within the scope of §2036 because it satisfies its three requirements.

1. There was a transfer of an interest in property for less than FMV consideration.
2. There was retention by the transferor of the right to use the property transferred.
3. The transferor retained the interest for his life.

The full FMV of the property on Auggie's date of death is therefore includable in his gross estate.

Note. IRC §2036(a)(1) requires possession or enjoyment of, or the right to the income from, the property transferred. IRC §2036(a)(2) deals with the right of the decedent, alone or in conjunction with any other person, to designate the person(s) who will possess or enjoy the income from the transferred property. Thus, §2036(a)(2) overlaps closely with §2038, discussed next.

IRC §2036 does not apply if the property transfer was a bona fide sale for adequate and full consideration in money or money's worth.[38] If less than full consideration is paid, the excess of the FMV of the property at the decedent's date of death over the amount of consideration received by the decedent for the property is includable in the gross estate.[39]

It is the FMV of the **entire property or portion of the property** in which the interest is retained that is included in the gross estate under §2036, not the value of the interest itself. For example, in *Estate of Adler v. Comm'r,*[40] the decedent conveyed an undivided one-fifth interest in a ranch to each of his five children during the decedent's life, retaining a life estate. The issue before the Tax Court was the value of the interest to be included in the decedent's gross estate under §2036. The estate argued that it should be the separate FMVs of each of the five undivided interests owned by the children. Doing so would result in valuation discounts attributable to the fractional interests. The court ruled that, although the decedent conveyed the undivided interests during life, for purposes of §2036 it was more akin to his having retained the entire property until death, with the undivided interests being conveyed at that time, because the retained interest had been in the entirety of the property. If the transferor retains an interest with respect to only a portion of the transferred property, the estate tax value of only that portion is included in the gross estate.[41]

There must be a **transfer** of property by the decedent **with a retained interest**. IRC §2036 is not applicable if an individual has **received** a beneficial interest in property from someone else rather than retaining the interest in property the individual transferred.

Example 7. David dies and leaves $4 million in a trust to pay the income to his wife, Elizabeth, for her life. When Elizabeth dies, the trust will terminate, and the trust principal will be distributed to their children. The $4 million is includable in David's gross estate, but does not generate an actual estate tax liability, as it is within David's basic exclusion amount (assuming David has not made other taxable gifts during his lifetime that, together with the $4 million, would exceed the basic exclusion amount.)

Although Elizabeth has the full beneficial enjoyment of the trust property during her life, at her death none of it is includable in her gross estate even if the principal of the trust at that time is greater than $4 million. This is because Elizabeth was given the beneficial interest by David. She did not herself make a transfer of the $4 million and retain the beneficial income interest.

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38. Ibid.
39. IRC §2043(a).
40. *Estate of Adler v. Comm'r,* TC Memo 2011-28 (Jan. 31, 2011).
41. Treas. Reg. §20.2036-1(c)(1)(i).

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Historically, this has been an important estate planning tool, as it allows married individuals to create a trust on the death of the first spouse to which assets up to the value of that spouse's basic exclusion amount can be transferred for the benefit of the surviving spouse without being included in the survivor's gross estate. Although less important with today's higher basic exclusion amount and portability election, there is no guarantee the exclusion amount will remain that high. Furthermore, it is not uncommon in second marriages for a spouse to provide for a surviving spouse using such a trust with remainder to the first spouse's children at the survivor's death.

Practitioner Planning Tip

Individuals who have failed to update their estate plans to account for higher basic exclusion amount may find themselves with an unnecessary trust on the death of the first spouse. Therefore, tax preparers should ensure clients revisit estate plans regularly.

Implied Retained Interest

If there is a formal transfer with a retained interest, such as a deed with a retained life estate, §2036 is applicable. Substance over form applies, and a retained right can exist by implication or by informal agreement of the parties even if it is unenforceable under state law.[42] This has often been the case, for example, when a decedent has made a complete transfer of property to a relative but continued to live on, have the use of, or have the income from the property after the transfer. Courts may find evidence of an **implied agreement** that the decedent was to continue to have full or partial beneficial use of the property, thus bringing the property within the scope of §2036.

This may not always be a disadvantage, however, especially with a $12.06 million applicable exclusion amount in 2022. If there will be no estate tax liability, the ability to assert that a transfer was made by a decedent with an **implied retained life estate means a FMV basis under §1014, which may result in considerable income tax savings.**

Example 8. Mother deeds her house to her children while she is alive and retains no life estate or other interest in the house. Mother's basis in the house is $100,000. Mother continues to live in the house until her death, paying no rent to the children and continuing to pay the property taxes, insurance, and maintenance on the house. Six months after mother's death, the children sell the house for $400,000.

Although, at first glance the children have a carryover gift basis[43] of $100,000, there may be a very good argument that there was an implied agreement among the parties that Mother was to have the use of the house until her death. If that is the case, the FMV of the house should have been includable in her gross estate under §2036. The children therefore have a basis for asserting that their income tax basis in the house is the $400,000 FMV on Mother's date of death.

Observation. One factor that might make it more difficult to argue for the application of §2036 to implied retention cases is the lack of estate tax consequences. In most cases this will now be an **income** tax issue, not an **estate** tax issue. Courts may therefore view efforts by transferees to step up basis through a §2036 implied retained benefit argument with a degree of skepticism and require a stronger taxpayer burden of proof. Therefore, if using an implied retained benefit for date of death FMV basis, factors supporting that position should be carefully documented and the documentation retained by all individuals who may claim that basis.

42. *Jane C. Guynn, Executrix of the Estate of Vena E. Calvert, Deceased v. U.S.,* 437 F.2d 1148 (4th Cir. 1971).

43. See IRC §1015.

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Whether there is an implied retention is a facts-and-circumstances issue. The Tax Court, discussing the Supreme Court's interpretation of the predecessor to §2036 in *Comm'r v. Estate of Church,*[44] noted that there is a "mandate for a broad inclusion within the gross estate" pursuant to §2036. The court went on to say that, in cases such as this, the burden of proof for non-inclusion is on the taxpayer and that burden may be a heavy one.[45] The following factors have tended to indicate an implied retention for purposes of §2036.

- A family relationship between the transferor and the transferees other than husband and wife[46]
- Continued occupancy or use of the property on a rent-free basis and withholding possession from the donee[47]
- Payment of taxes and expenses of the property[48]
- Making alterations or improvements to the property without the consent of the purported owners[49]
- Failure by the transferees to assert any rights with respect to the property during the occupancy of the transferor[50]
- Continued claiming of depreciation deductions on depreciable improvements to the property[51]
- Use of proceeds from a sale of the property after the transferor's death to pay obligations of the transferor's estate[52]
- Sale of the property by the transferees soon after the transferor's death[53]
- Continued control and management by decedent of agricultural land conveyed to a spouse[54]
- Continued receipt of income from transferred property by the transferor[55]
- Continued use of the property by the transferor in fact not ending before the transferor's death[56]

Observation. IRC §2036 has been used by courts to bring the FMV of property transferred to a family limited partnership (FLP) within a deceased transferor partner's gross estate because of implied retention of income or economic benefit from the assets transferred to the FLP.[57]

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44. *Comm'r v. Estate of Church,* 39, 335 U.S. 632 (1949).
45. *Estate of Linderme, Sr. v. Comm'r,* 52 TC 305 (1969).
46. These cases involve related parties. The courts' conclusions are therefore based on factors other than relationships. For example, in *Estate of Stavrakis v. Comm'r,* TC Memo 1992-229 (Apr. 20, 1992), the court said, "In the intrafamily context, where the decedent has not retained exclusive possession of the property, we have consistently rejected the applicability of section 2036 based solely on the family relationship where there is no express or implied agreement."
47. For example, see *Estate of Rapelje v. Comm'r,* 73 TC 82 (1979).
48. For example, see *Jane C. Guynn, Executrix of the Estate of Vena E. Calvert, Deceased v. U.S,* 437 F.2d 1148 (4th Cir. 1971).
49. Ibid.
50. For example, see *Estate of Rapelje v. Comm'r,* 73 TC 82 (1979).
51. For example, see *Estate of Baggett v. Comm'r,* TC Memo 1991-362 (Aug. 5, 1991).
52. For example, see *Estate of Linderme, Sr. v. Comm'r,* 52 TC 305 (1969).
53. Ibid.
54. *Estate of Hendry v. Comm'r,* 62 TC 861 (1974).
55. For example, see *Estate of Trombetta v. Comm'r,* TC Memo 2013-234 (Oct. 21, 2013).
56. For example, see *Jane C. Guynn, Executrix of the Estate of Vena E. Calvert, Deceased v. U.S,* 437 F.2d 1148 (4th Cir. 1971).
57. For example, see *Estate of Strangi v. Comm'r,* 417 F.3d 468 (5th Cir. 2005).

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However, the following factors have been found **not to support** the existence of an implied retained interest.

- Transfers by one spouse to another with the transferor spouse continuing to reside on the property with the transferee spouse[58]
- Use of less than all the property[59]
- Sharing use of the property with the donee[60]

Retained Voting Control

In *U.S. v. Byrum,*[61] the Supreme Court held that the stock of a closely held corporation was not includable in the decedent's gross estate where the decedent had irrevocably transferred the stock in trust. The decedent reserved the following powers.

1. Remove the trustee and appoint another corporate trustee
2. Vote the closely held stock
3. Veto the sale or other transfer of the trust property
4. Veto any change in investments

The Court found that the reserved rights did not constitute retained enjoyment of the stock or the right to designate the person(s) who would enjoy the stock or the income from the stock. In response to this, Congress added §2036(b). This provision treats the retention of the right to vote (directly or indirectly) shares of stock of the controlled corporation as being retention of the enjoyment of transferred property. It applies if:

1. The transfer was made after June 22, 1976;
2. The corporation was a controlled corporation at any time after transfer of that stock; and
3. The corporation was a controlled corporation at any time during the 3-year period ending on the decedent's death.

The stock is includable if it is held at death or if the right to vote was released within three years of death.

As defined in §2036(b)(2), a **controlled corporation** is one in which the decedent is treated as owning or having a right to vote stock possessing at least 20% of the total combined voting power of all classes of stock. In determining whether the 20% threshold is met, the **constructive ownership rules** of IRC §318 apply. The rule does not apply if the stock has no voting rights, or the decedent did not retain voting rights in the stock. The IRS issued proposed regulations on this provision in 1983 but has never finalized them.[62]

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58. For example, see *Estate of Gutchess v. Comm'r,* 46 TC 554 (1966), *acq.,* 1967-1 CB 2; Rev. Rul. 70-155, 1970-1 CB 189. However, see *Estate of Hendry v. Comm'r,* 62 TC 861 (1974), in which a husband conveyed to his wife a farm on which the husband had, for several years, been conducting citrus and cattle operations and on which, after the conveyance to his wife, he continued the exclusive conduct of those operations until his death 20 years later. The court considered this to be a retention of income from the property resulting in the farm's inclusion in his gross estate under §2036.

59. For example, see *Estate of Wineman v. Comm'r,* TC Memo 2000-193 (Jun. 28, 2000).

60. For example, see *Estate of Spruill v. Comm'r,* 88 TC 1197 (1987). "We have found no cases, and respondent has cited none, in which section 2036 has been applied to a decedent's transfer of legal title of a residence to his child, where the donor and donee thereafter co-occupy that residence until the decedent's death."

61. *U.S. v. Byrum,* 408 U.S. 125 (1972).

62. Prop. Treas. Reg §20.2036-2.

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IRC §2037: TRANSFERS TAKING EFFECT AT DEATH

IRC §2037 requires inclusion in the gross estate of "the value of any interest in property transferred by the decedent" during life "except to the extent the transfer was for an adequate and full consideration in money or money's worth" if all the following requirements are satisfied.

1. Possession or enjoyment of the property could, through ownership of the interest, have been obtained only by surviving the decedent.
2. Decedent retained a possibility that the property, other than the income alone, would return to the decedent or their estate or would be subject to a power of disposition by the decedent (a **reversionary interest**).
3. The value of the reversionary interest immediately before the decedent's death exceeded 5% of the value of the entire property.[63]

There are very few cases in which the value of property has been included in the gross estate under §2037 because such transfers are also normally subject to inclusion under §§2033, 2036, or 2038. In addition, the calculation of the possibility of a reversion must be done in accordance with the regulations under IRC §2031 dealing with valuation of future or conditional interests in property. The following are examples from the regulations illustrating §2037.[64]

Example 9. Drake transferred property in trust with the income payable to his wife for life and, at her death, the remainder to Drake's then surviving children, or if none, to Drake or his estate. Because each beneficiary can possess or enjoy the property without surviving Drake, no part of the property is includable in Drake's gross estate under §2037, regardless of the value of his reversionary interest. However, the value of the reversionary interest is includable in Drake's gross estate under §2033.

Example 10. Daniel transferred property in trust with the income to be accumulated for his life, and at his death, principal and accumulated income to be paid to Daniel's then surviving issue, or if none, to his widow Amy, or Amy's estate. Because Daniel retained no reversionary interest in the property, no part of the property is includable in his gross estate, even though possession or enjoyment of the property could be obtained by the issue only by surviving Daniel.

Example 11. Donavan transferred property in trust with the income payable to his wife for life and with the remainder payable to Donavan or, if he is not living at his wife's death, to his daughter or her estate. The daughter cannot obtain possession or enjoyment of the property without surviving Donavan. Therefore, if Donavan's reversionary interest immediately before his death exceeded 5% of the value of the property, the value of the property, less the value of his wife's outstanding life estate, is includable in his gross estate under §2037.

IRC §2038: REVOCABLE TRANSFERS

IRC §2038 requires inclusion in the gross estate of property to the extent a decedent made a transfer of that property during life, but in which the enjoyment of the property was subject, at the decedent's date of death, to any sort of power "by the decedent alone or by the decedent in conjunction with any other person to alter, amend, revoke, or terminate the transfer."[65]

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63. Treas. Reg. §20.2037-1(a).

64. Treas. Reg. §20.2037-1(e), Examples 1-3.

65. IRC §2038(a)(1).

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IRC §2038 is somewhat different from §2036(a)(1), which requires the decedent to **retain an interest** in the property until death. Under §2038, the decedent is not required to have retained individually a beneficial or ownership interest in the property. Instead, all that is required is retention by the decedent of the **power** in some manner **to affect** the enjoyment of the property by alteration, amendment, revocation, or termination of someone else's interest in the property.[66] This is very similar to inclusion under §2036(a)(2) where there is retention of the power to designate persons who will possess or enjoy the income from property. As a result, there is frequently an overlap of §§2036 and 2038, and inclusion may be found to exist under both provisions. Thus, the following discussion of inclusion under §2038 from retention of the power to alter, amend, revoke, or terminate an interest in property is also applicable to §2036(a)(2).

The classic example of the application of §2038 is the revocable living trust. When a living trust is created, the settlor of the trust transfers ownership of assets to the trustee. The trustee may be the settlor or a third party, such as a family member or a bank. The settlor, however, retains in the trust instrument the right to amend or revoke the trust in whole or in part. It is this power to amend or revoke that causes inclusion under §2038.

Observation. The classic revocable living trust is a grantor trust for income tax purposes. This requires all income and expenses of the trust to be reported on the grantor's individual return. Generally, therefore, no federal employer ID number (FEIN) is obtained for the trust and the grantor's social security number is used by third party payors for information return reporting. If a successor trustee assumes office, such as upon incapacity of the grantor-trustee, the trust remains a grantor trust reportable as such so long as the terms of the trust still permit revocation by the grantor. This would not change even if the successor trustee obtains an FEIN, as that simply requires filing a Form 1041, *U.S. Income Tax Return for Estates and Trusts,* as a grantor trust, with all trust income and expense items still reportable on the grantor's individual return.

For more information on FEINs, see the 2015 University of *Illinois Federal Tax Workbook,* Volume B, Chapter 3: Trust Accounting and Taxation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

In a revocable living trust, the settlor also retains the right to all the income from and use of the trust assets during life. This also constitutes a transfer of property with a retention of enjoyment for purposes of §2036(a)(2). In cases where both §2038 and §2036 can be applied, §2036 will usually be applied because it tends to require inclusion in the gross estate of a greater value of property.

If an individual establishes an irrevocable trust for the benefit of a third party and retains no right to amend or revoke the trust, it may seem §2038 is not applicable. For example, if the trust agreement gives the individual as trustee no more rights than any other trustee would normally possess under state law, the individual generally will not be considered to have retained a power subject to §2038.[67] This is because the individual will be limited by fiduciary principles in the exercise of managerial and administrative powers. It is possible however for an individual seemingly to create such a trust but retain powers that go beyond those permitted by §2038.

Example 12. Trish creates a trust with the income to be paid to Bob for 15 years. After 15 years, the principal will be distributed outright to Bob. Trish is the trustee of the trust and has no right to amend or revoke the trust. Generally, the powers that Trish has as trustee are those granted to her under the laws of the state. In addition, however, Trish retains the power to accumulate any of the income rather than distributing it to Bob, and to terminate the trust at any time by distributing the principal to him.

If Trish dies at any time during the period the trust is in existence, **§2038 will cause the entire value of the trust to be included in her gross estate.** This is because Trish has the power, through deferral of income or acceleration of distribution of the principal, to affect the time or manner of Bob's enjoyment of the property.[68]

[66] For example, see *Estate of Porter v. Comm'r,* 288 U.S. 436 (1933).

[67] For example, see *Estate of Ford v. Comm'r,* 53 TC 114 (1969), *aff'd per curium,* 450 F.2d 878 (2nd Cir. 1971).

[68] For example, see *Comm'r v. Estate of Newbold,* 158 F.2d 694 (2nd Cir. 1946); See, also, the example at the end of Treas. Reg. §20.2038-1(a).

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These principles have been applied by courts to transfers under the Uniform Gifts to Minors Acts (UGMA) when the person making the transfer is also the custodian. For example, in interpreting the Illinois UGMA, the Tax Court held (as has been the case with other states' acts) that the powers given the custodian under the Illinois UGMA are not subject to an ascertainable independent standard. This is because the custodian can effectively terminate the arrangement at any time, thus accelerating an interest, or can accumulate income, thereby deferring an interest.[69]

Even if an individual is not a trustee, retaining the power to remove a trustee and to replace the trustee with another can still result in estate inclusion because the decedent is considered to have all the powers of the trustee whom the decedent had the power to replace.[70]

IRC §2038 does not apply to the following situations.[71]

- To the extent that the transfer was for an adequate and full consideration in money or money's worth
- If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law
- To a power held solely by a person other than the decedent

In addition, **rights affecting administration or similar matters of a trust do not constitute retention of a power to modify, alter, or amend.** These include such things as the following.

- Powers limited by an ascertainable standard related to support, education, health, and maintenance of a beneficiary with respect to their accustomed way of life[72]
- Retention of broad administrative powers by the grantor-trustee when such powers were subject to state law limitations on the exercise of those powers[73]
- A provision relieving the grantor-trustee and any successor trustee from making reports or accountings to anyone other than the grantor[74]
- The right of the grantor-trustee to allocate receipts between principal and income[75]
- Retention of the power to control investment policy of trust[76]
- Reservation of the power to substitute other securities or property for those held by the trustee so long as the substituted property is of equal value to the property replaced[77]
- Reservation of a power to make additions to trust principal[78]
- A trust provision automatically including the settlor's after-born and after-adopted children as beneficiaries[79]

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69. *Stuit v. Comm'r,* 452 F.2d 190, 191 (7th Cir. 1971) (Illinois); *Estate of Prudowsky v. Comm'r,* 55 TC 890 (1971, *aff'd per curium,* 465 F2.d 62 (7th Cir. 1972) (Wisconsin); *Estate of Jacoby v. Comm'r,* TC Memo 1970-165 (Jun. 22, 1970) (Missouri).
70. Treas. Reg. §20.2038-1(a)(3).
71. Treas. Reg. §§20.2038-1(a)(1)-(3).
72. For example, see *Leopold and Keane, as Executors of the Estate of Hans G. M. de Schulthess, Deceased v. U.S.,* 510 F.2d 617 (9th Cir. 1974) (revised Jan. 2, 1975).
73. *Old Colony Trust Co. v. U.S.,* 423 F.2d 601 (1st Cir. 1970).
74. For example, see Ltr. Rul. 9314033 (Jan. 8, 1993).
75. For example, see *Estate of Pardee v. Comm'r,* 49 TC 140 (1967).
76. For example, see *Estate of Wurts v. Comm'r,* TC Memo 1960-102 (May 25, 1960).
77. *Estate of Jordahl v. Comm'r,* 65 TC 92 (1975), *acq.,* 1977-1 CB 1, and referenced in Rev. Rul. 82-5, 1982-1 CB 131.
78. *Estate of Johnston*, 2 TCM 299 (Jun. 22, 1943).
79. Rev. Rul. 80-255, 1980-2 CB 272.

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IRC §2039: ANNUITIES

IRC §2039 taxes the value of that portion of any annuity contract payable to someone else on account of a decedent's death to the extent the decedent was responsible for paying for the annuity. IRC §2039 typically applies to joint and survivor annuities and to annuities that pay for a term certain, and the owner dies before the end of the term. It does not matter that an individual was not in fact receiving an annuity, so long as, at death, the individual had a nonforfeitable right to receive it sometime in the future and that something is received by a beneficiary because of that right.[80]

The mere fact that a decedent was receiving an annuity does not cause any value to be included in the gross estate if the annuity terminates when the decedent dies.[81] That is because no one will receive anything of value from the annuity because of the decedent's death.

Example 13. Anna, who is single, is entitled to receive an annuity following her retirement. The annuity pays a monthly amount for the rest of her life starting at retirement and terminates upon her death. Because no one will receive anything of value from the annuity when Anna dies, none of the annuity is includable in her gross estate.

One estate planning tool that takes advantage of §2039 is the **private annuity.** This is a device by which an individual can sell property to a family member in exchange for a promise by the family member to pay the seller an annuity for the rest of the seller's life. The amount of the annuity payments is based on the FMV of the property and the actuarial life expectancy of the seller.[82]

If the property is sold in exchange for a private annuity, the seller has removed property from their estate. Although the seller will have received something of value in exchange — the annuity — its value will not be included in the seller's estate because the annuity will terminate on the seller's death. While private annuities can be effective estate planning tools, they can also create problems. The use of a private annuity should therefore be considered only with advice from a competent estate planner.[83]

IRC §2040: JOINT INTERESTS

IRC §2040 brings into the gross estate all interests held by a decedent with any other person(s) as joint tenants with right of survivorship or as tenants by the entirety (generally referred to in these materials as "joint interests"). For purposes of §2040, there is no distinction between joint tenancy with right of survivorship and tenancy by the entirety, although there are important differences between the two forms of ownership under state law. The section applies to any assets, real or personal, tangible or intangible, including joint bank accounts, so long as there is concurrent ownership by two or more persons and a survivorship feature.

Note. Joint tenancies with right of survivorship can be created among any individuals. Tenancies by the entirety can only be created and exist between spouses.[84] Under common law, termination of the marriage operates automatically to convert a tenancy by the entirety to a tenancy in common between the two former spouses.[85]

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80. Treas. Reg. §20.2039-1(b)(1).
81. IRC §2039(a).
82. For example, see General Counsel Memo 39503 (Jun. 28, 1985).
83. IRC §72; *Estate of Kite v. Comm'r,* TC Memo 2013-43 (Feb. 7, 2013).
84. Treas. Reg. §25.2515-1(b).
85. For example, see *Chock v. Chock,* 39 Haw. 657 (Haw. 1953), in which the court noted, "By the overwhelming great weight of authority, the legal effect of an absolute divorce is that it converts a tenancy by the entirety into a tenancy in common, each party being then possessed of a separate moiety in an estate subject to partition." Illinois permits a limited form of statutory tenancy by the entirety in a homestead rather than the common law form, but it also converts automatically to a tenancy in common upon divorce. 765 ILCS 1005/1b.

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Although the principles that apply to joint interests are essentially the same, the rules that determine the value of the interest includable in the gross estate of a joint owner differ depending on whether the individuals are married. The following discussion separately addresses unmarried and married individuals.

Unmarried Individuals

IRC §2040 addresses an issue of what Congress perceived to be indirect testamentary transfers of wealth.

Example 14. Donald buys Blackacre for $100,000 and pays the entire consideration. However, title is taken by Donald and Sarah as joint tenants with right of survivorship. At Donald's death, the FMV of Blackacre is $150,000. The entire $150,000 is includable in Donald's gross estate under §2040.

At first glance, this may seem a bit unfair. Under state law, Sarah was legally the owner of half the value of Blackacre before Donald's death. It might seem, therefore, that Sarah is acquiring from Donald only an additional half interest worth $75,000. Furthermore, the creation of the joint tenancy by Donald likely involved a taxable gift. All of this is irrelevant under §2040, however. **The only concern is who paid for the property.** Because Donald paid for all of it, all of it is includable in his gross estate.

The entire interest is taxed because at Donald's death, Sarah is actually getting ownership of the **entire** property interest, an interest derived solely from Donald's wealth. For estate tax purposes, therefore, Donald essentially disposed the entire value of the property because of his death. This is because if Sarah had died first, Sarah would have received nothing; but by surviving Donald, Sarah gets — not just half the property — but all of it. The fact that Donald may have been treated as making a taxable gift upon creation of the joint tenancy merely reflects Sarah's ability during Donald's life to take half the value of the property. That is very different from the fact that Sarah must survive Donald to get anything after his death. But by surviving Donald, Sarah gets it all.

If Sarah dies first, Donald becomes the sole owner at her death. The same **consideration rule** continues to apply. Because Sarah furnished none of the money for buying Blackacre, there is no transfer of Sarah's wealth to Donald because of her death. Therefore, none of the value of Blackacre is includable in Sarah's gross estate under §2040 even though Sarah legally owned half the value of Blackacre while alive and could have reduced that interest to sole possession by conversion to a tenancy in common or by sale.

Those being the basic principles, it is an easy step to **proportionate inclusion.**

Example 15. Use the same facts as **Example 14,** except Donald contributed ²/₃ of the purchase price of Blackacre and Sarah ¹/₃. At Donald's death, the FMV of Blackacre is $150,000. Because Donald furnished ²/₃ of the contributions, under §2040, ²/₃ of the value, or $100,000, is includable in his estate. If Sarah dies first, ¹/₃, or $50,000, is includable in her gross estate. If Sarah dies after Donald, the entire value is includable in her gross estate, but it is includable under §2033 because Sarah will then be the sole owner of Blackacre.

To keep people from circumventing the law, §2040 requires contributions to **originate** with an individual to count. Thus, if Donald gave Sarah the money to buy the ¹/₃ interest, all contributions would still be treated as Donald's.[86] But if Donald gave Sarah a sum of money that Sarah invested, Sarah's use of the income and gain from appreciation of the investments to purchase the ¹/₃ interest would not be included in Donald's gross estate.[87]

IRC §2040 solves the problem of identifying who paid for what by placing the burden of proof on the survivors. It does this generally by requiring **the full value** of jointly owned property to be included in the estate of the first joint tenant to die **except to the extent any surviving joint tenant(s) can prove contribution** toward the purchase of the property.[88] To that extent, the value of the property is removed from the decedent joint tenant's gross estate. If there are multiple joint tenants, the rule applies as each dies until only one owner remains.

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86. Treas. Reg. §20.2040-1(c)(4).

87. Treas. Reg. §20.2040-1(c)(5).

88. Treas. Reg. §20.2040-1(a); *Estate of Edna V.T. Peters,* 46 TC 407 (1966), *aff'd* 386 F.2d 404 (4th Cir., 1967).

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Practitioner Planning Tip

Tracing of contributions is required and makes good records and credible evidence critical. Courts generally hold that surviving joint tenants must be able to produce evidence proving contributions to qualify for removal of any part of a joint interest from an estate. Practitioners should remind clients of the importance of document retention to support the amount they paid to establish basis.

In tracing contributions, appreciation in value of the property is assigned in proportion to actual contributions.[89] But if income from the property is reinvested in the property, such as paying for a mortgage, an individual with no contribution credit can receive credit to the extent of that person's share of the reinvested income.[90]

Observation. While good records and credible evidence are essential in establishing contributions, courts have not been unreasonable and have employed use of the **Cohan rule** to estimate the amount a surviving joint tenant may have contributed, often based primarily on their credible testimony.[91] The *Cohan* case[92] established a rule of "indulgence" for deductions, which are otherwise subject to strict rules of interpretation. Under the *Cohan* rule, when a taxpayer is unquestionably entitled to a deduction or basis, but the amount is not adequately substantiated, the court may make an allowance based on an estimate. The court must be convinced, however, that (1) an expense was actually incurred by the taxpayer and (2) there is some basis upon which to estimate the allowance. Although originally applied to business expenses, *Cohan* has been used by the courts in many other areas for proof of contribution to a joint interest.

The following rules and examples are based on the regulations[93] and cases and summarize rules of inclusion.

- If the decedent paid the entire cost of jointly owned property, the entire value of the property is includable in the decedent's gross estate.[94] However, if the surviving joint tenant made improvements to the property, such cost is considered a contribution and reduces the value includable in the decedent's gross estate.[95]

  Example 16. Mary purchases property with her funds and titles it in her name and Pete's as joint tenants with right of survivorship. When Mary dies, the entire value of the property is includable in her gross estate. This rule applies regardless of whether the gift was taxable.

  Example 17. Use the same facts as **Example 16.** Pete made $10,000 of improvements to the property using his own funds. The value of the joint interest included in Mary's gross estate is the full FMV less Pete's $10,000 of improvements.[96]

89. Treas. Reg. §20.2040-1(a)(2).
90. Treas. Reg. §20.2040-1(c)(5)
91. For example, see *Estate of Fratini v. Comm'r,* TC Memo 1998-308 (Aug. 24, 1998), and cases cited therein.
92. *Cohan v. Comm'r,* 39 F.2d 540 (2nd Cir. 1930).
93. Treas. Reg. §§20.2040-1(c)(1)-(8).
94. Treas. Reg. §20.2040-1(c)(1).
95. For example, see *Estate of Peters v. Comm'r,* 386 F.2d 404 (4th Cir. 1967), *aff'g* 46 TC 407 (1966).
96. An issue on which there is no guidance concerns the effect of subsequent appreciation on the value of Pete's $10,000 improvement. For example, should appreciation (1) be ignored, and Pete's contribution remain fixed at $10,000; (2) share proportionately in the increase in value of the property from date of improvements; or (3) share proportionately and the increase in value of the property since creation of the joint interest? Each of these approaches raises issues of complexity and distortion and is beyond the scope of these materials.

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- If the decedent furnished no part of the purchase price, no part of the value of the property is includable in the decedent's gross estate.[97]

  Example 18. Use the same facts as **Example 17,** except that Pete dies before Mary. No part of the value of the property is includable in Mary's gross estate.

- If each co-owner paid only for their own share of the property with their own funds, the decedent's estate includes only the decedent's share.[98]

  Example 19. Mark and Paige purchase property as joint tenants with right of survivorship, with each paying half the cost. When Mark dies, half the value of the property is includable in his gross estate.

- If the survivor's interest was purchased with money gifted to them by the decedent, and the gifted money became the survivor's entire contribution to the purchase price, the decedent's gross estate includes the entire amount attributable to the gifted money.[99]

  Example 20. Use the same facts as **Example 19,** except that Paige's interest is purchased with money Mark gifted to her. If Mark dies first, all the value of the property is includable in his estate; if Paige dies first, none is includable in her gross estate.

- If the survivor's interest is purchased with income or proceeds from property gifted to them by the decedent, the survivor is treated as having contributed to the acquisition of the property to the extent of the post-gift portion of gain realized on disposition of the property.[100]

  Example 21. Use the same facts as in **Example 19,** except that Paige's interest is purchased with proceeds from the sale of securities previously gifted to her by Mark. At the time of the gift, the FMV of the securities was $100 and the carryover basis was $60. In addition, Paige reinvested $20 of dividends from the securities. The securities are sold for $140, which Paige uses to purchase her half interest in the property. Paige's basis, including dividend reinvestments, is $80 ($60 carryover basis + $20 reinvested dividends). Although there is $60 ($140 selling price – $80 basis) of gain, $40 of that is treated as gifted by Mark, leaving Paige with credit for contributing $20.

Observation. Although gain realized from post-gift property appreciation is considered contributed by the survivor, of the $40 of post-gift appreciation in value, $20 is attributable to the dividend reinvestments, for which Paige received credit through a $20 increase in basis. Without the dividend reinvestment, the FMV of the securities on disposition would have been $120, leaving Paige with $20 of post-gift gain treated as a contribution.

97. Treas. Reg. §20.2040-1(c)(3).

98. Treas. Reg. §20.2040-1(c)(2).

99. Treas. Reg. §20.2040-1(c)(4).

100. For example, see *Estate of Harvey v. U.S.,* 185 F.2d 463 (7th Cir. 1950).

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- If the decedent's interest and those of all other co-owners were acquired by gift or inheritance from third parties, a co-owner's estate includes their ratable share even though the interest expires upon their death.[101]

  Example 22. Mother retitles her residence in the names of Mother, Cole, and Claire as joint tenants with right of survivorship to avoid probate at her death.

  If Mother dies before Cole and Claire, the entire value is includable in her gross estate. Cole and Claire continue to own the residence as joint tenants. Upon the death of either one, half the value of the property is includable in their gross estate.

  If Cole dies before Mother, none of the value is includable in Cole's gross estate because he provided no consideration in acquiring his interest.

Observation. In **Example 22** when Cole dies before Mother, Mother and Claire increase their interests from $^1/_3$ to $^1/_2$ because each receives half of Cole's $^1/_3$ interest. However, neither of them receives a §1014 FMV basis because §1014(b)(9) requires a property interest to be includable in a decedent's gross estate for the transferee of that interest to receive a §1014 FMV basis. Because there was no inclusion in Cole's gross estate, there is no §1014 basis adjustment for Mother or Claire.

- It is not uncommon for individual to create joint checking, savings, or brokerage accounts. Generally, the following rules govern such accounts.

  a. State law controls the type of ownership interests created in joint accounts, whether based on the contributions of each to the account or a true joint tenancy with right of survivorship. If the latter, it does constitute a transfer of a half interest to the noncontributing account holder.[102]

  b. Creation of a joint account by the decedent with their funds is not a completed gift because the decedent retains the right to withdraw the funds.[103] A completed gift occurs when a noncontributing joint account holder makes withdrawals of funds contributed by the decedent without the need to account to the decedent.[104]

  c. Simply put, for estate tax purposes, tracing rules apply here just as with joint interests in any other property. The account is included in the estate of the first joint tenant to die except to the extent the survivors can prove contribution.[105]

Married Individuals

Prior to 1977, spouses were subject to the same rules under §2040 as were unmarried persons. This meant the entire value of assets owned as tenants by the entirety or joint tenants with right of survivorship would be included in the estate of the first spouse to die except to the extent the survivor could prove contribution. This could lead to harsh results, especially in the case of family businesses in which both spouses worked, because the IRS generally did not consider sweat equity to constitute a contribution in money or money's worth.

From 1977 to 1982, Congress enacted certain special provisions affecting the amount of spousal joint interests includable in the gross estate of the first spouse to die. This included the creation of the qualified joint interest under which 50% of the value of joint property was includable in the estate of the first spouse without regard to contribution. However, creation of the qualified joint interest was elective and required filing a gift tax return.

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101. Treas. Reg. §20.2040-1(c)(8).
102. For example, see *Estate of Buchholtz v. Comm'r,* TC Memo 1977-396 (Nov. 15, 1977).
103. Treas. Reg. §25.2511-2(c).
104. For example, see *Estate of Wilson v. Comm'r,* 56 TC 579 (1971).
105. For example, see *Magill v. Comm'r,* TC Memo 1982-148 (Mar. 24, 1982).

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For decedents **dying after December 31, 1981,** Congress eliminated the existing special provisions and established a flat rule for spouses: **in the case of a qualified joint interest, half the value of the property is includable in the estate of the first spouse to die without regard to contribution.**[106]

A **qualified joint interest** is defined as any tenancy by the entirety or joint tenancy with right of survivorship created after 1981 in which the spouses are the **only** joint owners.[107] This definition can create a problem in situations where parents put their children's names on property as joint tenants with right of survivorship with the parents, for example, for probate avoidance at the deaths of the parents. When the first parent dies, the property will not be a qualified joint interest, meaning the presumption of full inclusion and the contribution tracing rules will apply.

> **Note.** Joint property interests passing to a surviving spouse **who is not a U.S. citizen generally** is not a qualified joint interest. This means the **contribution rules apply to such transfers.** There are exceptions if the property passes to a qualified domestic trust (QDOT), or the spouse becomes a U.S. citizen before the estate tax return for the deceased spouse is filed and was a U.S. resident at all times after death of the decedent.[108]

The combination of the qualified joint interest rule and the unlimited marital deduction means there will be no estate tax at all on the death of the first spouse if all assets owned by the spouses are held as tenants by the entirety or joint tenants with right of survivorship. This is because the entire interest of the first spouse in the jointly owned property will be treated as passing to the surviving spouse upon the death of the first spouse and will qualify for the marital deduction.

Example 23. Frank and Francine, who are husband and wife, have combined assets of $4 million, all jointly owned. The basic exclusion amount is $2 million in the year Frank dies. Half of the value of the property, $2 million, is included in Frank's gross estate. Because the entire $2 million passes automatically to Francine and is subject to inclusion in her gross estate, Frank's estate is entitled to a marital deduction for the $2 million. There is no estate tax because of Frank's death.

Assuming no change in values, when Francine dies, the entire $4 million of property is includable in her gross estate. Because she is able to pass only $2 million with no estate tax, the additional $2 million of value that was included in Frank's estate is now taxed in Francine's estate.

> **Observation.** The preceding example illustrates an estate planning problem known as **over-qualification of the marital deduction**. Because all the property in Frank's estate qualified for the marital deduction, his taxable estate was zero. Frank's estate was therefore unable to utilize his $2 million basic exclusion amount that would have allowed him to pass the $2 million with no estate tax and without using the marital deduction. The marital deduction is mandatory, however, and an estate cannot elect not to use it.[109] This is discussed later in this chapter.

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106. *Gallenstein v. U.S.*, 975 F.2d 286 (6th Cir., 1992). See especially the court's recap of the history of IRC §2040 in part B "The Statute" at 288-289.

107. IRC §2040(b).

108. IRC §2056(d).

109. *Estate of La Sala v. Comm'r,* 71 TC 70 (1979); Rev. Rul. 59-123, 1959-1 CB 248. IRC §2056 provides that the taxable estate **shall** be determined by taking into account the marital deduction.

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Gallenstein Situations

It has been commonly accepted after 1981 that, upon the death of the first spouse, half the value of joint tenancy or tenancy by the entirety property is includable in their gross estate. This changed in 1992 with respect to pre-1977 spousal joint tenancies, however, with the decision of the Sixth Circuit in *Gallenstein v. U.S.*[110]

In 1955, Mrs. Gallenstein and her husband purchased a farm in Kentucky. They paid $38,500 for the property, all of which was derived from her husband's earnings. The property was held by them as joint tenants with right of survivorship. **Gallenstein's husband died in 1987** and she became the sole owner as the surviving joint tenant. In 1988, she **sold 73.6 acres of the farm for $3,663,650.** Under the terms of the contract, she received $800,000 in 1988, with the remainder to be paid in installments over five years.

On her 1988 federal income tax return, Gallenstein initially reported a capital gain from the sale of the property based on a net sale price of $3,659,596 and an adjusted basis of $103,000 resulting in a taxable gain of $3,556,596. In May 1989, she filed an amended return for 1988 showing $1,838,658 as her adjusted basis for the property. This reduced her gain from $3,556,596 to $1,815,725. She sought a refund of $105,395 of the tax she paid on the first installment payment.

In 1989, Gallenstein filed a second amendment to her 1988 return. She claimed an adjusted basis in the property of $3,663,650, the gross sale price of the property. This amount reflected an **amended federal estate tax return** filed by her husband's estate that claimed the **full value of the property was includable in his gross estate.** This was based on the premise that she had contributed nothing to the acquisition of the property and that §2040 required inclusion of the entire FMV in her husband's estate, entitling her to a corresponding basis under §1014.

The IRS refunded the amount claimed on her first amended return but denied the second refund. Gallenstein sued for refund in U.S. District Court and won. The United States appealed to the Sixth Circuit. At issue was whether the consideration-furnished rule continued to apply to pre-1977 spousal joint tenancies after 1981. The Sixth Circuit, affirming the District Court, effectively ruled that pre-1977 spousal joint tenancies are still subject to the consideration rule if they have not been converted to qualified joint interests after 1976. This rule was subsequently adopted by the Tax Court, followed by an IRS acquiescence.[111]

The present status of spousal joint tenancies appears to be as follows.

- **For joint tenancies created prior to 1977, the consideration rule of §2040(a) applies.**
- For joint tenancies created from **1977 through 1980,** the contribution rule applies unless there was an election to treat creation of the joint tenancy as a qualified joint interest.
- **For joint tenancies created after 1981, the 50% rule applies.**

Caution. It is important to understand about pre-1977 spousal joint tenancies that one cannot assume there is an automatic step up in basis merely because of the presumption that all the joint property is includable in the estate of the first spouse to die. The Tax Court held in *Madden v. Comm'r*[112] that the presumption does not entitle the surviving joint tenant to an increase in basis under §1014 **unless the surviving joint tenant made a good faith effort to prove contribution.**

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110. *Gallenstein v. U.S.,* 975 F.2d 286 (6th Cir. 1992).

111. *Hahn v. Comm'r,* 110 TC 140 (1998), *acq.,* AOD/CC-2001-06, IRB 2001-42 (Oct. 15, 2001).

112. *Madden v. Comm'r,* 52 TC 845 (1969), *aff'd per curium,* 440 F.2d 784 (7th Cir. 1971); followed, *Normoyle v. Comm'r,* TC Memo 1969-199 (Sep. 29, 1969); The joint interest must have been includable — that is required to be included — in the gross estate, not just included by the executor in calculating the gross estate.

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The IRS may try to require the survivor to prove there was no contribution by that individual and that the decedent provided all the consideration. However, no cases or rulings have been found in which the IRS has done so. Nevertheless, it is important to understand what did and did not constitute consideration under pre-1977 law to properly advise clients. The following are some general rules of contribution in spousal cases in addition to those discussed previously for unmarried individuals.

- If the consideration came from a gift made by the decedent, it does not count as consideration; only income or profits in excess of the gift that go back into the property count.[113]
- If jointly owned property is acquired through a mortgage, income from the property is presumed to have helped pay for it, meaning each spouse will be presumed to have contributed.[114]
- If jointly held property is subject to a mortgage under which the decedent and surviving spouse had joint and several liability during their lives, with continuing liability for the survivor, liability for that indebtedness may be treated as the survivor's contribution to acquisition of 50% of the mortgaged property.[115] This is true even if the decedent was the only one making payments on the mortgage; such payments merely affect the portion includable in the decedent's gross estate.[116]
- Facts showing that the spouses both worked together in businesses or income-producing activities may serve to establish a partnership intent resulting in each being credited with contributing consideration for jointly owned property. This is a common argument with respect to jointly owned business assets.[117]
- Services normally performed by a spouse as a homemaker or that are traditionally associated with family do not constitute consideration. This is the case even though the spouse may also have performed some duties associated with a family business when those duties do not rise to the level of creating a partnership.[118]
- If the decedent brought capital to the marriage in the form of existing property or funds from which the property was acquired and the surviving spouse brought none, this weighs heavily in favor of inclusion of the entire interest in the decedent's gross estate, especially if, after the marriage, the decedent generally controlled a business in which the property was used.[119]

Practitioner Planning Tip

Before taking a position that a surviving spouse client is entitled to treat 100% of jointly owned property as includable in the estate of a deceased spouse under *Gallenstein*, a practitioner should document facts supporting inclusion and demonstrating lack of contribution by the surviving spouse and retain the documentation with the client's file.

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113. For example, see *Estate of Kelley v. Comm'r,* 22 B.T.A. 421 (Feb. 27, 1931); Treas. Reg. §20.2040-1(c)(4).

114. For example, see *Estate of Drummond v. Paschal,* 75 F.Supp. 46 (E.D. Ark. 1948).

115. *Bremer v. Luff,* 7 F.Supp. 148, 156 (N.D.N.Y. 1933); Rev. Rul. 79-302, 1979-2 CB 328.

116. See Rev. Rul. 79-302, 1979-2 CB 328, for calculation.

117. For example, see *U.S. v. Estate of Neel,* 235 F.2d 395 (10th. Cir. 1956); *Estate of Otte v. Comm'r,* TC Memo 1972-76 (Mar. 28, 1972). Also see *Estate of Ensley v. Comm'r,* TC Memo 1977-402 (Nov. 21, 1977). Most of the value of joint business interests in which both spouses worked is brought to the marriage by the husband. Consequently, although the wife was credited with being an informal partner, she was unable to establish the value of her services relative to the combination of the husband's original capital investment and his services.

118. For example, see *Estate of Loveland v. Comm'r,* 13 TC 5 (1949). ("Services performed by a wife under a marriage contract do not represent consideration in money or money's worth" for purposes of the predecessor to §2040.)

119. For example, see *Estate of Kjorvestad v. U.S.*, No. A78-2077 (D.C. N.D. 1981).

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> **Caution.** *Gallenstein* was a taxpayer victory. Technically, however, if Mrs. Gallenstein had died first, there would have been no inclusion in her gross estate and therefore no step up in basis under §1014. The survivor has the burden of proving how much of the value is attributable to their contributions, which reduces the amount includable in the first spouse's gross estate. **Failure to prove there was no contribution by a surviving spouse in a *Gallenstein* situation does not default to 50% inclusion because it is not a qualified joint interest**.

IRC §2041: POWERS OF APPOINTMENT

A power of appointment is not an ownership interest in property itself. Instead, it is a power given to some person to take away the ownership of a property interest from one person and to give it to another person. For estate planning purposes, there are two types of powers of appointment.

1. General powers of appointment
2. Limited or special powers of appointment

Powers of appointment can be exercisable during the lifetime of an individual or may be exercisable only at the individual's death through their will. The terms **lifetime** and **testamentary** are used respectively in this chapter to indicate whether a power is exercisable during life or only at death.

A **general power of appointment** allows the decedent to appoint property to anyone, including the decedent, creditors of the decedent, the decedent's estate, or creditors of the decedent's estate.[120] A power that is exercisable only in conjunction with the creator of the power or a person having a substantial adverse interest in the property, or that is limited by an ascertainable standard, is not a general power of appointment. If an individual dies holding a general power of appointment over property, §2041 requires the value of the property over which the power is held to be included in the individual's gross estate.

> **Example 24.** Fred transfers real property to Gloria by deed. Gloria is the owner of the entire interest in the property. In the same deed, however, Fred gives to Gloria's brother, George, a general power of appointment over the property exercisable by deed. George has the ability to execute a deed in which he exercises his power of appointment to remove ownership of the property from Gloria and to transfer ownership to anyone he chooses, including himself. If George dies still holding this power, **the entire value of the property is includable in his gross estate, resulting in adjustments to FMV basis.** This is true even though, if Gloria dies after George, the value of the entire property is includable in her gross estate.

A general power of appointment is often used for purposes of qualifying trusts for the marital deduction. Upon the death of the first spouse, two separate trusts are created: a credit shelter (or bypass) trust funded in an amount equal to the maximum basic exclusion amount available to that spouse's estate, and a second trust intended to qualify for the marital deduction.

To qualify for the marital deduction, the assets of the marital deduction trust must be includable in the surviving spouse's gross estate.[121] If the only right the surviving spouse has in the trust during life is to receive income and distributions of principal under an ascertainable standard, this would be a **terminable interest** (one that terminates with the death of the beneficiary) and would therefore not qualify for the marital deduction.[122] To cure this, the trust can give the surviving spouse a testamentary general power of appointment over the assets of the marital portion of the trust. Under the testamentary power, the survivor has the ability by will to appoint the marital deduction trust to anyone, including the survivor's estate. The ability to appoint property to one's estate is sufficient under §2041 to bring the value of the property into the gross estate and thereby qualify the marital trust for the marital deduction.[123]

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120. IRC §2041(b)(1).

121. See IRC §2056.

122. IRC §2056(b).

123. IRC §2056(b)(5).

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The marital deduction trust qualifies for the marital deduction by being includable in the survivor's gross estate, but the survivor does not have any ability (other than under an ascertainable standard of invasion) to access the principal during life. This approach is still used by some practitioners today, although the QTIP election (discussed later) accomplishes the same thing without requiring that the surviving spouse have a testamentary general power of appointment.

A **limited or special power of appointment** allows an individual only to appoint property to someone other than the individual or the individual's estate or creditors, such as the decedent's descendants, and is not a general power of appointment.[124] Because the decedent, as the individual holding the power, does not have the ability to benefit economically or to benefit the decedent's estate from its exercise, §2041 does not apply to the value of property subject to the power.

IRC §2041 is expressly not applicable to any general power that is limited by an **ascertainable standard** relating to the health, education, support, or maintenance of the holder of the power.[125] This exception is a very important estate planning tool, as it allows the use of a credit shelter trust to keep assets out of the surviving spouse's gross estate, while at the same time allowing the survivor to use up the entire principal of the trust to the extent necessary under certain limited conditions. It is therefore possible through a combination of income distributions to the surviving spouse and a power of invasion under an ascertainable standard to give the survivor nearly as much benefit from the trust as one could have, yet without causing the trust to be included in the survivor's gross estate.

Per statute, an ascertainable standard must be stated only in terms of needs relating to health, education, support, or maintenance, or any combination of those. The use of any other terms may be treated by the IRS as constituting a general power of appointment under §2041, which will cause the principal of the trust to be included in the gross estate of the decedent. In particular, any mention of the ability for principal to be used for such things as comfort, welfare, or happiness may be considered as not limited by the required standard.[126] The whole point of the ascertainable standard is that there be some objective standard a court could use in determining whether a condition of need exists that would entitle the beneficiary to a distribution of principal for that need. It is not necessary, however, that the beneficiary first exhaust any other resources, although such a limitation is sometimes included in a trust.[127]

Observation. With the combination of a high basic exclusion amount and portability election, it is generally unnecessary at the death of the first spouse for their estate plan to include both a credit shelter trust and a marital deduction — whether the latter is through a testamentary power of appointment or a QTIP election. What is more likely for smaller estates is the often unnecessary creation of a credit shelter trust on the death of the first spouse because their estate plan has not been updated in years or decades and the relatively high basic exclusion amount ($12.06 million for 2022) causes the decedent's entire estate to be allocated to the credit shelter trust.

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124. Treas. Reg. §20.2041-1(c)(1).

125. IRC §2041(b)(1)(A); Treas. Reg. §20.2041-1(c)(2).

126. Treas. Reg. §20.2041-1(c)(2).

127. Ibid.

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IRC §2042: PROCEEDS OF LIFE INSURANCE

IRC §2042 brings into the gross estate the proceeds of insurance on a decedent's life when the proceeds are receivable by, or for the benefit of, the decedent's estate, or are payable to any other beneficiaries under any policy in which the decedent possessed any incidents of ownership at death.[128]

Insurance proceeds are considered receivable by the personal representative if they are actually paid to the decedent's probate estate, are used to settle claims against the decedent or the decedent's estate, or are subject to obligations of the probate estate without regard to whether such obligations are actually satisfied out of the insurance proceeds. This rule applies without regard to whether the decedent possessed any incidents of ownership in the policy under which the benefits are payable.[129]

With respect to payments to any other beneficiaries, the decedent must have retained some incident of ownership in the policy and must possess such incident of ownership at death for the proceeds to be includable. **Incidents of ownership** are not defined specifically under §2042 but are generally viewed as including the following.

- The right of the insured or the insured's estate to the economic benefits of the insurance
- The power to change the beneficiary
- The power to surrender or cancel the policy
- The power to assign the policy
- The power to revoke an assignment
- The power to pledge the policy for a loan
- The power to obtain from the insurer a loan against the surrender value of the policy[130]
- A reversionary interest exceeding 5% of the value of the policy immediately before the death of the insured that the insured or the insured's estate may regain an incident of ownership in the event of certain contingencies[131]

Payment of premiums by the decedent is not considered an incident of ownership.[132] Therefore, one spouse can assign all incidents of ownership in a life insurance policy on that spouse's life to the other spouse and continue paying premiums without having retained an incident of ownership subject to §2042.[133]

If a corporation has a life insurance policy on the life of its sole shareholder, the regulations and cases are in agreement as follows.[134]

- If the proceeds are payable to the corporation, there is no attribution to the shareholder, as proceeds are reflected in the increased value of the corporate stock, which will be an asset of the gross estate.[135]
- If the proceeds are payable other than to, or for the benefit of, the corporation, however, there is attribution of the incidents of ownership to the shareholder.[136]

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128. Treas. Reg. §20.2042-1(a)(1).

129. Treas. Reg. §20.2042-1(b)(1).

130. Treas. Reg. §20.2042-1(c)(2).

131. Treas. Reg. §20.2042-1(c)(3).

132. Under the 1939 Code, payment of premiums by decedent caused inclusion in the decedent's gross estate. The 1954 Code eliminated payment of premiums as a factor in determining inclusion under §2042. See S. REP. No. 1622, 83d Cong., 2d Sess. 472 (1954) at XXXIII. Estate Tax, F. Proceeds of life insurance: "No other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property and to discriminate against life insurance in this regard is not justified."

133. For example, see Treas. Reg. §20.2042-1(c)(1).

134. Treas. Reg. §20.2042-1(c)(6).

135. For example, see *Estate of Huntsman v. Comm'r,* 66 TC 861 (1976); Treas. Reg. §20.2031-2(f).

136. Treas. Reg. §20.2042-1(c)(6).

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The regulations also provide that the same rule must apply to any shareholder who has a controlling interest in the corporation, meaning ownership of stock possessing more than 50% of the total combined voting power of the corporation. However, there is no clear court case authority in this regard.

Example 25. Elizabeth is the controlling shareholder of Crystal Springs Corporation. Crystal Springs maintains two life insurance policies on Elizabeth. The proceeds of one policy are payable to the corporation and the proceeds of the other policy are payable to her husband. Elizabeth is treated as retaining incidents of ownership held by Crystal Springs Corporation with respect to the policy payable to her husband, but not the policy payable to Crystal Springs.[137]

There is no mention in the regulations of the treatment of partnerships or limited liability companies classified as partnerships. Partnerships are not separate taxable entities. They are, instead, merely the aggregate of the individual partners. It would seem logical, however, to apply essentially the same principles to partnerships. Thus, if insurance proceeds are payable to the partnership, this should be reflected by the increased value of the interest of the deceased partner. If that is the case, also including the proceeds under §2042 would result in double counting for estate tax purposes, which is what the regulations dealing with corporations try to avoid. On the other hand, if the proceeds are payable to some other beneficiary, or are in any manner not reflected by an increase in value of the deceased partner's interest in the partnership, there is good policy reason to attribute the partnership's incidents of ownership to the partner.

Any attempt to transfer incidents of ownership in an insurance policy to another individual to prevent application of §2042 must take §2035 into account. One of the few transfers subject to §2035 is that of insurance policies. Therefore, a transfer within three years of death of any incident of ownership in a life insurance policy will cause the policy to be brought into the gross estate under §2035.

Observation. One of the commonly used methods to remove a life insurance policy from the estate is the use of an irrevocable life insurance trust.

IRC §2044: CERTAIN PROPERTY FOR WHICH MARITAL DEDUCTION WAS PREVIOUSLY ALLOWED

In calculating the taxable estate of a decedent or taxable gifts of a donor, a marital deduction is generally allowed for the value of property that passes to a spouse. **However,** as discussed in the next section, the property interest passing to the spouse cannot be a terminable interest, such as a life estate. If the spouse does receive a terminable interest, an exception to the terminable interest rule may be possible in the case of QTIP. The QTIP provision basically allows a decedent's personal representative or a donor to elect to qualify the QTIP for the marital deduction, notwithstanding that the surviving spouse has received a terminable interest in the property. The marital deduction and QTIP election are discussed in the next section.

The sole purpose of §2044 is to exact the price that must be paid for taking a marital deduction in QTIP. What it says, quite simply, is that the value of the QTIP is includable in the estate of the surviving spouse even though it is otherwise a terminable interest that would not be subject to inclusion under any other provision of the estate tax. It is the **value of the property at the death of the surviving spouse** that is used, not the value at the time the QTIP election is made. Because §2044 requires QTIP to be included in the estate of the surviving spouse, it qualifies for FMV basis under §1014.[138]

Note. Although the remainder in QTIP assets will have passed automatically to the remainder beneficiaries, IRC §2207A authorizes the surviving spouse's estate to recover from the remainder beneficiaries any estate tax attributable to inclusion of the QTIP in the estate of the surviving spouse.

137. Ibid.

138. IRC §1014(b)(9)(C).

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MARITAL DEDUCTION

IRC §2056 permits an unlimited marital deduction in the estate of a spouse for property passing to the surviving spouse. The purpose of the marital deduction as it exists today is essentially to treat spouses as a single asset acquisition unit for purposes of the estate and gift taxes so their combined wealth will be taxed only once. There must, however, be at least one opportunity for it to be taxed. Thus, property may be taxed in the estate of the first spouse to die or in the estate of the second spouse to die. It is the marital deduction (or lack of it) that operates as the "switch" to determine in which spouse's estate the property may be taxed.[139]

If property includable in the estate of the first spouse to die satisfies these requirements, the value of that property **must** be treated as qualifying for the marital deduction. It is not possible to elect to treat property as not qualifying for the marital deduction if it otherwise does qualify.[140]

To qualify for the marital deduction, property must satisfy the following requirements.

1. It must be included in the gross estate of the first spouse to die.
2. It must pass to the surviving spouse.
3. It must be includable in the estate of the surviving spouse if the property is still owned by that spouse at death.[141]

Example 26. Assume the basic exclusion amount is $3 million. Henry and Wanda have total assets of $6 million, all owned as joint tenants with right of survivorship or tenants by the entirety. Henry dies and has a gross estate of $3 million because half the value of the joint property is includable in his gross estate under §2040. All the $3 million in Henry's estate passes to Wanda as a surviving joint owner. If Wanda still has the property at her death, it is includable in her gross estate. It therefore qualifies for the marital deduction in Henry's estate, meaning his taxable estate is zero and there is no estate tax. Therefore, none of his basic exclusion amount is used.

When Wanda dies, she has $6 million in her estate, but is able to pass only $3 million of that to her beneficiaries with no estate tax. The remaining $3 million is taxed. Thus, because of the mandatory marital deduction in Henry's estate, his basic exclusion amount is wasted **(over-qualification of the marital deduction).**

> **Note.** See the later discussion on portability election that can permit use of Henry's unused basic exclusion amount in Wanda's estate.

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139. *Estate of Heim v. Comm'r,* 914 F.2d 1322 (9th Cir. 1990).

140. *Estate of La Sala v. Comm'r,* 71 TC 70 (1979); Rev. Rul. 59-123, 1959-1 CB 248. Section 2056 provides that the taxable estate shall be determined by taking into account the marital deduction.

141. IRC §2056.

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A classic estate planning technique divides assets between the spouses in such a way that each spouse can direct where assets go at death in place of the automatic rules of joint ownership. This may be done through tenancies in common or separate trusts for each spouse. The estate plan is then designed in a manner that intentionally flunks the requirements for the marital deduction. This is done by creating a terminable interest for the surviving spouse in all or a portion of the first decedent's assets. A **terminable interest** does not qualify for the marital deduction because it is not includable in the estate of the surviving spouse.[142] It is defined as possessing all the following characteristics.[143]

1. It is an interest in property that will terminate upon the occurrence or non-occurrence of an event or upon the lapse of time.
2. Another interest in the same property passes or passed from the decedent to someone other than the spouse for less than adequate consideration.
3. Such other person is able to possess or enjoy a part of such property upon the termination of the spouse's interest.

Example 27. Use the same facts as **Example 26,** except all the couple's assets are owned as equal tenants in common, giving each separate control over their half value of the assets. Henry dies and has a gross estate of $3 million. Instead of giving it all to Wanda, the estate plan directs that $3 million be placed in a trust that pays the income to Wanda for life, with remainder to their children at the Wanda's death.

This plan creates a terminable interest for Wanda of $3 million, meaning it does not qualify for the marital deduction. It is a terminable interest because it has all the following conditions.

1. It is an interest in property (the life income) that terminates upon the happening of an event, the death of the surviving spouse.
2. At the same time, the life income interest is created in the surviving spouse, the remainder interest passed to the children, meaning the property passes to them for less than adequate consideration because they paid nothing for the interest.
3. The children as remainder beneficiaries will be able to possess or enjoy the property upon the termination of the spouse's interest.

The survivor has the use of the trust assets without causing their value to be includable in the survivor's gross estate. In addition, there is usually a power to invade principal for the benefit of the survivor under an ascertainable standard. The remainder beneficiaries will automatically possess all interests in the property at the death of the surviving spouse. Such trusts are commonly referred to as **credit shelter trusts** or **bypass trusts.**

The creation of the credit shelter trust is usually done using a formula that causes an amount equal to the maximum basic exclusion amount available to the decedent's estate to be used to fund the credit shelter trust, with anything in excess of that going to the surviving spouse outright or continuing to be held in trust in a manner that qualifies for the marital deduction. The result is that the estate of the first spouse to die is able to use their full basic exclusion amount, as is the estate of the surviving spouse. By using such a plan, the couple in **Example 27** can each use their respective $3 million basic exclusion amounts to pass $6 million with no estate tax rather than only $3 million.

A disadvantage to the use of credit shelter trusts is that assets used to fund that trust receive a §1014 FMV basis only at the death of the first spouse and not again at the death of the second spouse because the assets of the trust are not includable in the survivor's gross estate. The remainder beneficiaries will therefore receive assets at the death of the surviving spouse with bases determined at two different times: the death of the first spouse for assets in the credit shelter trust, and the death of the second spouse for their assets.

Similarly to jointly owned property, the surviving spouse is entitled to a basis in the property that is half the survivor's original basis in the property and half the §1014 basis of the property on the first spouse's death.

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142. IRC §2056(b).

143. *Estate of Allen v. U.S.,* 359 F.2d 151 (2nd Cir. 1966), *cert. denied* 385 U.S. 832 (1966).

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Example 28. Kurk and Karen own a business. Their total assets have an FMV of $4 million. Half of all assets are held in separate revocable trusts established by each spouse as grantor, trustee, and beneficiary. The total FMV of Kurk's gross estate is $2 million, and the adjusted basis of the assets is $1 million. Kurk's trust requires setting aside an amount equal his basic exclusion amount ($12.06 million) in a credit shelter trust to pay the income to Karen for life with an ascertainable standard of invasion and remainder at her death to their children. As a result, **all** the $2 million of assets of Kurk's trust are allocated to the credit shelter portion.

Kurk's trust has a basis in its half of the assets of $2 million. Karen continues to have a basis of $1 million in her half of the assets. Assume at Karen's death the FMV of the assets in each trust is $3 million and both trusts have an adjusted basis in their depreciable assets of $500,000. The children will receive all the assets but will have two bases: $500,000 of carryover basis from Kurk's trust and a §1014 FMV basis of $3 million from Karen's trust.

Example 29. Use the same facts as **Example 28,** except that all $4 million of assets are jointly owned and were acquired after 1981. The assets have an adjusted basis of $2 million. Because it is a qualified joint interest, $2 million (half the value) is includable in Kurk's gross estate. Karen therefore has a basis in the assets of $3 million ($2 million attributable to the value includable in Kurk's estate + $1 million attributable to Karen's half of the remaining adjusted basis in her half interest). Upon Karen's death, **all the property** is includable in her gross estate and receives a full FMV basis of $6 million.

QTIP ELECTION

If a surviving spouse has a terminable interest in property, the value of that property normally does not qualify for the marital deduction. Since 1976, however, §2056(b)(7) has permitted an election to qualify a terminable interest for the marital deduction. To make the election, the property in which the surviving spouse has the terminable interest must be **QTIP**. This is commonly referred to as a **QTIP election.** The effect of making a QTIP election is to qualify the value of the elected property for the marital deduction, notwithstanding that the surviving spouse has only a terminable interest in the property and has no general power of appointment over it. The estate planning price paid for marital deduction qualification is that §2044 (discussed previously) requires the value of the QTIP for which marital deduction treatment was elected to be included in the gross estate of the surviving spouse.

Although with a higher basic exclusion amount and the portability election, the use of credit shelter trusts may be unnecessary (or even undesirable) for most individuals, the use of an irrevocable trust after the death of the first spouse may still be useful for second marriages, asset protection, or incapacitated surviving spouses.

With the use of QTIP election, however, it may still be possible to employ a combination of irrevocable trust, marital deduction, and portability election to ensure maximum income tax bases for remainder beneficiaries.

Example 30. Use the same facts as **Example 27.** At Henry's death, an unnecessary credit shelter trust was created. But if Henry's trust files a federal estate tax return on which it makes a QTIP election to qualify all assets of the credit shelter trust for the marital deduction and also makes a portability election, then the trust assets receive a §1014 FMV basis and all income is distributable to Wanda. At Wanda's death, however, the QTIP assets — in other words the entire credit shelter trust — are required to be included in her estate under §2044. These assets therefore receive a second §1014 FMV basis at the same time the assets in Wanda's trust do. In addition, if Henry's executor makes a portability election, Wanda has available Henry's $12.06 million DSUE plus her own basic exclusion amount.

Caution. In Rev. Proc. 2016-49,[144] the IRS said it will disregard certain unnecessary QTIP elections. However, the Rev. Proc. does permit QTIP elections that are not necessary for purposes of eliminating estate tax liability if they are combined with a portability election. It is also possible intentionally to fail to satisfy the requirements of the revenue procedure.

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144. Rev. Proc. 2016-49, 2016-42 IRB 462 (modifying and superseding Rev. Proc. 2001-38, 2001-1 CB 1335).

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IRC §2056(b)(7) sets out the requirements for the QTIP election.

1. The property must be included in the gross estate of the deceased spouse and must pass from the decedent in the same manner as for the marital deduction.
2. The surviving spouse must be entitled to a qualifying income interest for life. This means that all income must be distributable at least annually only to the surviving spouse.
3. No other beneficiary may have any rights in the property during the surviving spouse's life. Any principal distributions must, under the terms of the instrument, be made only to the surviving spouse and to no one else.
4. An irrevocable election must be made to treat the property as QTIP.

The QTIP election must be made on the last estate tax return filed by the due date of the return, including extensions, **or**, if a timely return is not filed, the first estate tax return filed after the due date. The election is made on Schedule M, *Bequests, etc., to Surviving Spouse*, of Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, simply by listing the property in the "A" section of that form labeled "*QTIP property*." A protective QTIP election can be made if, when the estate return is filed, there is a bona fide issue concerning the includability of an asset in the decedent's gross estate or the amount or nature of the property to which the surviving spouse is entitled.[145]

The QTIP election can be made with respect to all assets of a trust or a partial interest if it relates to a defined fraction or percentage of the entire trust in assets, or by means of a formula election.[146] For example, a formula could be used to treat as QTIP only the trust assets necessary (after taking into account the decedent's applicable exclusion amount) to reduce the decedent's estate tax to zero.

> **Note.** The QTIP election is an important estate planning tool in the context of the marital deduction because the usual approaches to marital deduction planning generally involve the use of formulas that are created **prior** to death and operate automatically on values existing as of date of death. In contrast, the QTIP election essentially allows waiting until **after** the death of the first spouse to decide how much property to qualify for the marital deduction. It is, in other words, as if the formula itself is not created until after death.

Another important use for the QTIP election is in second marriages. It may be that the spouses want to use their separate assets each to benefit the other but want ultimately for those separate assets to go to their own children. The use of a QTIP trust can permit this if the total value of the assets is in excess of the first spouse's basic exclusion amount. Otherwise, if estate tax is not an issue, an irrevocable trust may be used to direct income (and possibly principal) be distributed to the surviving spouse and the remainder to the deceased spouse's children.

Example 31. Wilma and Harrison have each been married before and each has children from their prior marriages. They have no children together from their marriage. Wilma dies in 2022 with a gross estate of $3.5 million when the basic exclusion amount is $3 million. To avoid estate tax completely at her death, she needs $500,000 of marital deduction. She can leave the entire $3.5 million in trust to pay the income to Harrison for life and, at his death, to be distributed among her children.

Wilma's personal representative or trustee can qualify $500,000 of her estate for the marital deduction by making a QTIP election for that amount. The remainder of the $3 million is covered by her basic exclusion amount.

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[145] See instructions for Form 706.

[146] Treas. Reg. §20.2056(b)-7(b)(2)(i).

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In fact, the QTIP election should not be stated as an amount equal to $500,000. Instead, the election should be made in terms of a formula rather than a fixed amount. The formula should take into account any changes that might occur, such as by examination, that could change the amount needed as a marital deduction. The formula could be something as simple as the smallest amount necessary to reduce the taxable estate to $3 million.

Practitioner Planning Tip

Practitioners would be well served to seek assistance from someone with expertise in this area.

PORTABILITY ELECTION

Note. These materials deal with **making** the portability election and not on use of that election by a surviving spouse.

The basic exclusion amount is not an estate tax deduction. Instead, it is $12.06 million (in 2022) worth of unified credit against the estate tax. Because the marital deduction causes the taxable estate to be zero, there is no tax and, consequently, no unified credit is used. The estate of the second spouse to die is then limited to only the basic credit of that spouse. The basic credit of the first spouse is therefore wasted. To avoid this result, estate plans traditionally have generally resorted to credit shelter trusts as described previously. Since 2011, however, there has been an additional tool available under the Code.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[147] introduced the concept of **portability** of the basic exclusion amount between spouses as an additional means of avoiding ill consequences from over-qualification of the marital deduction. For years after 2010, the estate of the first spouse to die can elect to "port" the unused basic exclusion amount of the deceased spouse to the surviving spouse. In theory, therefore, over-qualification of the marital deduction can now be avoided by making a **portability election** in the estate of the first spouse. Because none of the first spouse's basic exclusion amount was used due to the marital deduction, if a portability election is made, the decedent's entire $12.06 million credit is available to the surviving spouse's estate. This results in the survivor having $24,120,000 of applicable exclusion amount and (ignoring any increases or decreases in the basic exclusion amount at the death of the survivor) therefore no estate tax liability. The amount of exclusion ported from the deceased spouse's estate is known as the DSUE.

MAKING THE ELECTION

The executor of the decedent's estate must make a portability election on a timely-filed estate tax return.[148] For filing purposes, the portability election is treated as being a return required to be filed under IRC §6018.[149] The due date of an estate tax return making a portability election is therefore nine months after the decedent's date of death or the extended due date, which is an additional six months. This applies regardless of whether the value of the decedent's gross estate is less than the §6018 filing threshold and an estate tax return is otherwise not required to be filed under §6018.

147. *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,* PL 111-312.

148. Treas. Reg. §20.2010-2(a).

149. Treas. Reg. §20.2010-2(a)(1).

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The due date for a Form 706 that is below the filing threshold and is filed solely for purposes of making a portability election is set by regulation, not by statute. The IRS has authority under Treas. Reg. §301.9100-3 to grant extensions.[150] The IRS has issued numerous letter rulings pursuant to Treas. Reg. §301.9100-3 granting extensions of time to elect portability in situations where the decedent's estate was not required to file an estate tax return because it was less than the decedent's basic exclusion amount.

To reduce the number of ruling requests for 9100 extensions, the IRS issued Rev. Proc. 2022-32[151] providing a simplified method for certain estates to obtain automatic extension of time to make portability elections. Relief under the simplified method is available to the estate of any decedent satisfying all the following requirements.

1. The decedent was survived by a spouse, died after December 31, 2010, and was a citizen or resident of the United States on the date of death.
2. The executor is not required by §6018 to file an estate tax return based on the value of the gross estate and adjusted taxable gifts, but without regard to the need to file for making a portability election.
3. The executor did not file an estate tax return within the prescribed time for filing.
4. The executor has not already filed a timely estate tax return.

The executor must also satisfy the requirements of §4.01 of the revenue procedure. This means the executor must file a **complete and properly prepared** Form 706 on or before the fifth anniversary of the decedent's date of death. The Form 706 must state at the top that the return is "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)." If these requirements are satisfied, a portability election will be treated as timely made. If, however, it is subsequently discovered that, based on the value of the gross estate (taking into account any taxable gifts), the executor was required to file an estate tax return under §6018(a), the grant of an extension under the simplified method is deemed null and void from the outset.

A portability election will be treated as **not** having been made if the executor states affirmatively on a timely filed estate tax return or attachment thereto that the estate is not electing portability under §2010(c)(5). The Form 706 contains a box at part 6, section A as shown that can be checked if an estate tax return is being filed and the executor wants to elect out of portability.

Form 706 (Rev. 8-2019)

Estate of:	Decedent's social security number

Part 6—Portability of Deceased Spousal Unused Exclusion (DSUE)

Portability Election

A decedent with a surviving spouse elects portability of the DSUE amount, if any, by completing and timely filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount.

Section A. Opting Out of Portability

The estate of a decedent with a surviving spouse may opt out of electing portability of the DSUE amount. Check here and do not complete Sections B and C of Part 6 only if the estate opts **NOT** to elect portability of the DSUE amount. ☐

B. Qualified Domestic Trust (QDOT) Yes No

150. Often referred to simply as "9100 extensions."

151. Rev. Proc. 2022-32, 2022-30 IRB 101, modifying Rev. Proc. 2017-34, 2017-26 IRB 1282.

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The election out is also treated as made if no estate tax return is timely filed.[152] The last estate tax return filed on or before the due date (including extension if granted) determines whether there is a portability election. At the end of that time, the election or failure to elect becomes irrevocable.[153]

IRC §2203 defines the term **executor** as the appointed executor or administrator of decedent, which usually means the probate estate. If there is no such appointed executor, any person in actual or constructive possession of any property of the decedent may file an estate tax return on behalf of the estate and make or reject the portability election. These individuals are referred to in the regulations as **non-appointed executors.**[154] Once a non-appointed executor has made a portability election, the election cannot be superseded by another non-appointed executor of the same decedent's estate unless that person is the successor of the non-appointed executor who made the election. A subsequently appointed probate executor, however, should be able to make or supersede a prior election or non-election.[155]

Note. For more information on electing the DSUE, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Beneficiary and Estate Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

RETURN REPORTING

The election must be made on a **complete and properly prepared estate tax return.**[156] A return satisfies this requirement if it is prepared in accordance with existing regulations under §6018 and the Form 706 instructions that are applicable to all estate tax returns.[157] However, in response to requests for simplification the regulations provide a special rule — referred to as **the simplified rule** — for returns that are under the §6018(a) filing threshold and are being filed only for purposes of the portability election. Executors of such estates generally do not have to report the actual value of certain property that qualifies for the marital or charitable deduction, referred to in this chapter as **eligible property**. An executor choosing to make use of this rule must do the following.

1. Report the description, ownership, and beneficiary (if there is one) of the eligible property together with all other information necessary to establish the right of the estate to the marital or charitable deduction, including any additional requirements or guidance in the Form 706 instructions on the proper schedule where the property would be listed on without regard to the simplified rule.
2. Estimate the total value of the gross estate consisting of the sum of:
    a. Eligible property, the individual value of which does not have to be reported on the estate tax return under this provision; and
    b. The properly determined value of property not eligible for the simplified rule.

The estimated total value of the gross estate must be based on a determination made in good faith and with due diligence regarding the value of all the assets includable in the gross estate.[158] Thus, while the actual value of eligible property does not have to be shown on any schedule of the estate tax return, the executor must still know the approximate FMV of the eligible items.

152. Treas. Reg. §20.2010-2(a)(3).
153. Treas. Reg. §20.2010-2(a)(4).
154. Treas. Reg. §20.2010-2(a)(6)(ii).
155. Treas. Reg. §20.6018-2.
156. Treas. Reg. §20.2010-2(a)(2).
157. Ibid.
158. Treas. Reg. §20.2010-2(a)(7)(ii)(B).

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The simplified rule does not apply to marital or charitable deduction property unless it meets one or more of the following requirements.[159]

1. The value of such property relates to, affects, or is needed to determine the value passing from the decedent to another recipient.
2. The value of such property is needed to determine the estate's eligibility for the provisions of §2032 (alternate valuation date), §2032A (special use valuation), §6166 (installment payments of estate tax), or another estate or GSTT tax provision of the Code for which the value of the property or of the gross are adjusted gross estate must be known, but specifically excluding §1014.[160]
3. Less than the entire value of an interest in property includable in the decedent's gross estate is marital deduction property or charitable deduction property.
4. A partial disclaimer or partial QTIP election is made with respect to a bequest, devise, or transfer of property includable in the gross estate, part of which is marital deduction property or charitable deduction property.

Observation. The exceptions are saying that if the value of marital or charitable deduction property is relevant for determining the FMV of property included in the gross estate that may pass to anyone else, that may be a component in a formula, or that is necessary in determining the application of another provision of the Code; it is no longer eligible property for the simplified rule. Therefore, the actual FMV of the property must be shown on the schedule where the property is listed. This means, for example, that an estate plan with a classic marital deduction formula clause dividing the estate between a credit shelter trust and a marital deduction portion will prevent use of the simplified rule unless the estate makes a QTIP election to qualify the credit shelter portion for the marital deduction.

For purposes of the simplified rule, the Form 706 instructions provide ranges of dollar values for the estimated value of the total gross estate. The executor must identify on the estate tax return the particular range within which the executor's best estimate of the value of the total gross estate falls. The 2021 Form 706 instructions require an estimate rounded up to the nearest $250,000. For example, if the estimated value is more than $1,500,000 but less than or equal to $1,750,000, the value to be used is $1,750,000. **No individual values are reported on the different schedules** on which eligible property is listed. Instead, **only the total value of all eligible property** is reported on lines 10 and 23 of part 5.

Observation. Because only marital and charitable deduction property are eligible for the simplified rule, over- or under-valuation of that property will have no effect on calculation of the DSUE because the value of eligible property on the recapitulation schedule first increases the gross estate (line 10) as an asset, then decreases it (line 23) by the same amount as a deduction in determining the taxable estate.

Caution. If any assets are included in the gross estate that are not eligible for the simplified valuation rule, **all the normal estate tax valuation and substantiation rules apply** that are required for any estate tax return.

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159. Treas. Reg. §20.2010-2(a)(7)(ii)(A).

160. The exclusion of §1014 simply means the actual FMV of assets will be used for income tax purposes, not the estimated value under the simplified rule is used on the Form 706.

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By signing the return, the executor is certifying, under penalties of perjury, that the estimate falls within the identified range of values to the best of the executor's knowledge and belief. The inquiry required to determine the executor's best estimate is the same an executor of any estate must make under current law to determine whether the estate has a filing obligation pursuant to §6018(a).[161] There is no guidance on how an executor satisfies such duty of inquiry.

Practitioner Planning Tip

Although the simplified valuation rule might make preparation of the Form 706 somewhat easier and less expensive, practitioners need to be aware that accurate valuations are still required for income tax purposes for property eligible for date-of-death FMV basis under §1014. The simplified rule for the portability election therefore cannot be used for basis purposes if values are based on estimates.[162]

The following examples, adapted from the regulations,[163] illustrate the application of the estimation rule, including reporting eligible property on the Form 706. In particular, **Example 32** illustrates how eligible property should be reported on Form 706.

Example 32. Assume the following facts.

- Juan dies in 2022
- Juan is survived by his wife, Maria
- Both Juan and Maria are U.S. citizens
- Juan's gross estate is less than the applicable exclusion amount for 2022
- Juan has made no taxable gifts over the total amount of Juan's adjusted taxable gifts
- Juan's executor timely files Form 706 solely to make the portability election

The assets includable in Juan's gross estate consist of a parcel of real property, joint bank accounts with Maria, a life insurance policy payable to Maria, and a survivor annuity payable to Maria for her life. The executor files an estate tax return Form 706 on which these assets are identified on the proper schedules. Thus, the real property is listed on Schedule A, *Real Estate*; the joint bank accounts on Schedule E, *Jointly Owned Property*; and the annuity on Schedule I, *Annuities*. The executor does not list the values on those schedules, leaving blank the columns in which values would be shown. The values are instead included on lines 10 and 23 of part 5.

To establish the estate's entitlement to the marital deduction, the executor includes the following on Schedule M for each of these items: evidence to verify the title of each jointly held asset, to confirm that Maria is the sole beneficiary of both the life insurance policy and the survivor annuity, and to verify that the annuity is exclusively for Maria's life. Finally, by signing the estate return, the executor certifies the estimates are the executor's best estimates of the FMV of the gross estate determined by exercising due diligence. The estate tax return is considered complete and properly prepared, and the executor has elected portability.

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161. Treas. Reg. §20.2010-2(a)(7)(ii)(B).

162. See Treas. Reg. §20.2010-2(a)(7)(ii)(A)(2).

163. Treas. Reg. §20.2010-2(a)(7)(ii)(C), Examples 1-3.

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Example 33. Use the same facts as **Example 32.** Juan's will provides that his entire estate is to be distributed to a QTIP trust for Maria. The non-probate assets includable in Juan's gross estate consist of a life insurance policy payable to Juan's children from a prior marriage, and Juan's individual retirement account (IRA) payable to Maria.

The executor files an estate tax return on which all the assets includable in the gross estate are identified on the proper schedules. The probate assets and the IRA are eligible property, so no information is provided regarding date of death value. However, the executor makes a QTIP election by listing the probate assets on Schedule M as "QTIP property" and attaches a copy of Juan's will creating the QTIP. The executor also describes each such asset and its ownership to establish the estate's entitlement to the marital deduction. In the case of the life insurance policy payable to Juan's children, all the regular return requirements apply, including reporting and establishing its FMV. Finally, the executor certifies on the estate return the executor's best estimate, determined by exercising due diligence, of the FMV of the gross estate. The estate tax return is considered complete and properly prepared, and the executor has elected portability.

Example 34. Use the same facts as **Example 33,** except that there are no non-probate assets, and the executor elects to make only a partial QTIP election. In this case, the simplified valuation rule is not available and the regular return requirements apply to **all** the property includable in the gross estate and the special valuation rules do not apply.

Example 35. Use the same facts as **Example 34,** except that Juan's will provides that 50% of the property passing under the will is to be paid to a marital trust for Maria and 50% is to be paid to a trust for Maria and their descendants.

The amount passing to the non-marital trust cannot be verified without knowledge of the full value of the property passing under the will. As a result, the value of the property of the marital trust relates to or affects the value passing to the trust for Maria and the couple's descendants. Therefore, the general return requirements apply to **all** the property includable in the gross estate and the special valuation rules do not apply.

CALCULATING SURVIVING SPOUSE'S DSUE

The executor of the deceased spouse's estate must complete part 6, Section C of Form 706 to calculate the DSUE ported to the surviving spouse. This is the **lesser of:**

1. The basic exclusion amount in effect in the decedent's year of death, **or**
2. The **excess of:**
   - a. The decedent's applicable exclusion amount, **less**
   - b. The amount on which the tentative tax (estate tax calculated on the sum of the taxable estate and adjusted taxable gifts) was determined on the estate of the deceased spouse.

Solely for purposes of computing the decedent's DSUE, the amount of the adjusted taxable gifts of the decedent is reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gifts.

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The regulations use the following examples to illustrate computation of the DSUE.[164]

Example 36. In 2002, having made no prior taxable gift, Hank makes a taxable gift valued at $1 million and reports the gift on a timely filed gift tax return. Because the amount of the gift is equal to the applicable exclusion amount for that year, $345,800 is allowed as a credit against the tax, reducing the gift tax liability to zero.[165] Hank dies on September 29, 2011 and is survived by his wife, Martha. Hank and Martha are U.S. citizens, and neither was previously married. Hank's taxable estate is $1 million. The executor of Hank's estate timely files Hank's estate tax return and elects portability, thereby allowing Martha to benefit from Hank's DSUE.

The executor of Hank's estate computes Hank's DSUE to be $3 million (the lesser of the $5 million basic exclusion amount in 2011,[166] or the excess of Hank's $5 million applicable exclusion amount over the sum of the $1 million taxable estate and the $1 million amount of adjusted taxable gifts).

Example 37. Use the same facts as **Example 36,** except that the value of Hank's taxable gift in 2002 is $2 million. After application of the applicable credit amount, Hank owes gift tax on $1 million ($2 million gift – $1 million applicable exclusion amount for that year). Hank pays the gift tax owed on the transfer in 2002.

On Hank's death, the executor of his estate computes the DSUE to be $3 million (the lesser of the $5 million basic exclusion amount in 2011, or $3 million (Hank's $5 million applicable exclusion amount – ($1 million taxable estate + $1 million adjusted taxable gifts))). Hank's adjusted taxable gifts of $2 million were reduced for purposes of this computation by $1 million, the amount of taxable gifts on which gift taxes were paid.

Note. If a surviving spouse remarries, they are still entitled to the DSUE of the deceased spouse. However, if the new spouse dies, the DSUE of the first deceased spouse is no longer available to the surviving spouse who must then use the DSUE of the second deceased spouse (if any).

IRS EXAMINATION OF RETURNS

Upon examination, the IRS may adjust or eliminate the DSUE reported on the estate tax return. However, the IRS may assess additional tax on the deceased spouse's return only within the statute of limitations for assessment (generally three years after the return is filed). The ability of the IRS to examine returns of a deceased spouse applies to each transfer by the surviving spouse to which a DSUE is or has been applied. Thus, if the surviving spouse uses the DSUE over time on the survivor's return and the executor uses the remainder on the survivor's estate tax return, IRS can examine the deceased spouse's return on each of those transfers to challenge the amount of the DSUE. The returns and return information of a deceased spouse may be disclosed to the surviving spouse or the surviving spouse's estate as appropriate.[167]

There is one Tax Court case addressing the ability of the IRS to examine the deceased spouse's estate tax return to determine the correct DSUE on the surviving spouse's estate tax return. In that case, the Tax Court held that the IRS did have explicit statutory authority to audit a predeceased spouse's estate tax return for purposes of determining the correct DSUE within the period of limitations applicable to the surviving spouse's estate tax return. In addition, the court held that the examination of the deceased spouse's return was not the equivalent of a second examination of the surviving spouse's return.[168]

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164. Treas. Reg. §20.2010-2(c)(5), Examples 1 and 2.

165. See Instructions for Form 706, line 9 — Unified Credit (applicable credit amount). ("The applicable credit amount (formerly the unified credit) is $345,800 for the estates of decedents dying in 2002.")

166. IRC §2010(c)(3).

167. IRC §2010(c)(5)(B); Treas. Reg. §20.2010-3(d).

168. *Estate of Sower v. Comm'r,* 149 TC 279 (2017).

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PROS AND CONS OF PORTABILITY

At first glance, making a portability election might seem to be an easy choice, and in many cases that may be so. In the real world, however, whether to make the election is a much more complex decision.

Observation. Even with the simplified rules, preparation of Form 706 to elect portability is not a simple task. Practitioners who are not familiar with preparing Form 706 should be cautious in doing so. Use of appropriate return preparation software rather than fillable PDF forms is recommended.

Pros

- The election can preserve the basic exclusion amount of the first spouse to die when that would otherwise be wasted as a result of all assets that pass to the surviving spouse qualifying for the marital deduction, thereby reducing the decedent's taxable estate to zero.
- In the event of a decrease in the basic exclusion amount in future years, the survivor's applicable exclusion amount will include the potentially higher DSUE of the deceased spouse.
- In the event all assets are left to the surviving spouse and a portability election is made, there is a double basis step up: half the value of the assets on the death of the first spouse and all the assets on the death of the second. There will then be the combined applicable exclusion amount of the two spouses against any tax from inclusion of all assets in the surviving spouse's estate.

Note. As discussed previously, a double basis step up can also be achieved with a credit shelter trust by combining a QTIP election with a portability election.

Cons

- Even with simplified valuation rules for marital and charitable deduction assets, preparing the Form 706 requires time and expense. If there are assets ineligible for simplified valuation, the costs could increase significantly.
- The "forever audit" rule for the estate of the deceased spouse means their Form 706 must be carefully prepared and all substantiating documentation be retained and accessible indefinitely. Failure to do so can result in loss of the DSUE.
- The continued use of credit shelter trusts may be desirable for several reasons, such as asset protection; removing future appreciation from the surviving spouse's estate; in the case of second marriages; and state death tax planning.
- While the deceased spouse's basic exclusion amount can be ported, their GSTT exemption amount cannot.
- The DSUE is not indexed for inflation.
- If the surviving spouse remarries and their new spouse predeceases them, they will have lost the DSUE of the first spouse because the DSUE is limited to that of the last deceased spouse.
- In the case of second marriages and blended families, there may be conflict over costs associated with a portability election that favors heirs of the surviving spouse.
- It is likely that the issue of portability elections will increasingly be addressed in prenuptial agreements.

Practitioner Planning Tip

Practitioners should determine whether there is a post-2010 prenuptial agreement before recommending a portability election. If there is one, consider getting a legal opinion of its effect, if any, on the decision to port.

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State Case

Although the focus of the discussion on portability has been on the federal rules, a state court decision illustrates that this may have ramifications on administration of decedent's estates under state law. This may be especially true in the case of second marriages or if the basic exclusion reverts to a lower amount in the future. In the case of *In re Estate of Vose v. Lee,*[169] the Supreme Court of Oklahoma affirmed a lower court decision requiring the executor of a probate estate to make a portability election. The executor was the son of the decedent. Her surviving husband was not the father of the executor. The couple had a comprehensive prenuptial agreement executed in 2006 under which each waived rights in the estate of the other. The lower court ordered the executor to make the portability election and the husband to pay the costs of doing so. In its opinion, the Oklahoma Supreme Court, following an extensive review of the portability election, addressed the following issues and arguments.

Preemption. The executor argued that the portability election, being federal law, preempted state law under the supremacy clause of the Constitution. The court said that the doctrine of preemption did not apply in this situation. The issues presented arose under probate law, which is state law. Preemption applies only when there is a clear conflict between state law and federal law or that in some manner interferes with congressional intent. The executor argued that because §2010 gives the executor the discretion to make the portability election a state court cannot order him to do so. The court rejected this argument, saying that nothing in the statute, regulations, or legislative history had any bearing on how the executor's discretion is to be exercised. In fact, the court relied on the preamble to the final regulations[170] in which the IRS acknowledged that prenuptial agreements could affect the election. Similarly, a probate court could appoint a surviving spouse as the executor solely for purposes of filing an estate tax return and making the portability election.

Lack of Standing. The executor next argued that the husband lacked standing to bring his case because, pursuant to the prenuptial agreement, he was not an heir of the decedent and therefore could have no interest in her estate. The court said Oklahoma law requires an individual to have a pecuniary interest in a decedent's estate to have standing. For this purpose, however, a pecuniary interest can exist through the ability of a portability election to increase the husband's applicable exclusion amount, which is independent of his inability to take as a legal heir.

Effect of Prenuptial Agreement. The court noted that the couple had an extensive prenuptial agreement that, in places, made specific reference to statutory provisions. A prenuptial agreement is basically a contract and can be used to waive or modify rights that a party may otherwise have under applicable law. To waive such rights, however, the waiver must be made with full knowledge of the rights intended to be waived. Because the prenuptial agreement was executed in 2006 and the portability election did not come into existence until 2010, it was not possible for the prenuptial agreement to be interpreted as a waiver by the husband of something of which he had no knowledge or could foresee.

Fiduciary Duties. The court said that, although the executor had discretion under §2010 with respect to the election, Oklahoma state law places the executor in a fiduciary relationship with respect to all parties having an interest in the estate. This would include the interest of the husband in the portability election.

Detriment to the Estate. Finally, the executor argued that the husband should be required to pay consideration to the estate in exchange for the estate making the portability election. He also argued that making the election would extend considerably the period in which the decedent's estate tax return can be audited. The court responded by noting that the lower court had ordered the husband to pay the costs of the election and that any risk to the estate was outweighed by the executor's fiduciary obligation to preserve the assets of the estate and to safeguard the husband's interest in the DSUE.

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169. *In re Estate of Vose v. Lee,* 390 P.3d 238 (Okla. 2017).

170. TD 9725, 2015-26 IRB 1094.

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FILING ESTATE RETURN IF NOT REQUIRED

No estate tax return is required to be filed unless the value of the gross estate exceeds the basic exclusion amount in effect for the decedent's year of death ($12.06 million for 2022).[171] The filing requirement is based on the **value** of the gross estate, **not** whether there is an estate tax due.

> **Example 38.** Demarco dies in 2022. The value of his gross estate is $15 million, all of which passes to his surviving spouse and qualifies for the marital deduction. Demarco's taxable estate is therefore zero and there is no estate tax due. Because the value of the gross estate exceeds the 2022 basic exclusion amount, his estate must file a Form 706.

> **Example 39.** Use the same facts as **Example 38,** except that Demarco does not have a surviving spouse, and his estate has a $6 million DSUE from a spouse who predeceased Demarco. Demarco's estate is still required to file an estate tax return because the filing requirement is based on his estate's **basic exclusion amount**. The DSUE is added to Demarco's basic exclusion amount to determine the estate's **applicable exclusion amount** but is disregarded under §6018(a)(1) in determining the filing requirement threshold.

It may be beneficial to file an estate tax return even if the gross estate is below the basic exclusion amount. It may be desirable, for example, to file a Form 706 to **start the statute of limitations.** This might be the case if the gross estate is less than the basic exclusion amount, but there are potential valuation issues that could cause the gross estate to exceed that amount and require a return. So long as the return is properly prepared it should start the statute of limitations on assessment.[172]

The other aspect of filing an estate tax return is when the value of the gross estate is less than the threshold at which a return is required under §6018. The value of property as reported on the estate tax return is deemed to be its FMV under §1014.[173] It might seem, therefore, that filing an estate tax return for income tax purposes could serve to **document the FMV of property of the gross estate.** In fact, this is not the case. The IRS ruled long ago that the filing of an estate tax return when one is not required by §6018 to be filed is a nullity with respect to the determination of other federal tax liabilities.[174] Furthermore, if property is overvalued on the estate tax return and that value used as income tax basis by a beneficiary, the IRS could impose valuation misstatement or other appropriate penalties on the beneficiary unless the beneficiary had a reasonable basis for relying on the valuation.[175]

> **Observation.** IRC §1014(f) establishes a basis consistency rule under which the income tax basis of property generally cannot exceed the final value reported on the estate tax return. However, this rule only applies to property includable in a decedent's gross estate that increases the estate tax liability above credits allowable to the estate against the tax. In other words, there must be an estate tax liability actually payable. Because so few estates are currently subject to the consistency rule, it is not covered in these materials.

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171. IRC §6018(a)(1).

172. For example, see *Estate of Lohman v. Comm'r,* TC Memo 1972-27 (Feb. 3, 1972). (Estate tax return prepared by an individual with "Tentative Return" hand printed at the top of the first page was sufficient to start the statute of limitations because it gave the IRS sufficient information to compute and determine the tax even though one asset was omitted.)

173. Treas. Reg. §1.1014-3(a).

174. For example, see Rev. Rul. 56-60, 1956-1 CB 443. ("Accordingly, it is held that where the value of the decedent's gross estate at the date of death does not exceed the statutory exemption of $60,000, a Federal estate tax return, Form 706, filed with respect to the estate is not a return as contemplated by section 6918(a)(1) [sic — should be 6018(a)(1)] of the Code. Because the return will not be recognized for Federal estate tax purposes, it follows that any material contained therein would have no force or effect with respect to its application in the determination of any other Federal tax liability.")

175. Rev. Rul. 85-75, 1985-1 CB 376, interpreting IRC §6659, Addition to Tax in the Case of Valuation Overstatements for Purposes of the Income Tax, moved to §6662(e) as part of the consolidation of penalties in the Omnibus Budget Reconciliation Act of 1989.

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