# 2022
# National Income Tax Workbook

CHAPTER 2: TRUSTS & ESTATES

PP 45 - 71

Land Grant University
Tax Education Foundation

# Chapter Topics P 45

- Basis of Inherited Assets
- Sale of Inherited Assets
- Gifts in Contemplation of Death
- Irrevocable Life Insurance Trusts
- Qualified Personal Residence Trusts
- Gift and Estate Tax on §529 Plans

# Learning Objectives P 45

- ➢Determine the basis of inherited assets
- ➢Characterize gains or loss on sale of inherited assets
- ➢Identify predeath gifts included in the donor's gross estate
- ➢Understand the use of irrevocable life insurance trusts
- ➢Explain the requirements for a qualified personal residence trust
- ➢Calculate the value of a gift to a qualified personal residence trust
- ➢Know when there is gift or estate tax on §529 plan assets

# Basis of Inherited Assets

# Introduction P 46

- 2022 $ 12,060,000 basic exclusion
- Portable – amount unused by one spouse transfers to the other

# Determining Basis - I.R.C. §1014 P 46

1. FMV at the date of death
2. I.R.C. §2032 election, value on alternate valuation date
3. I.R.C. §2032A election, special use valuation for qualified real property
4. Applicable exclusion under I.R.C. §2031(c)
   - Qualified conservation easement
   - Basis in the hands of the decedent

# Practitioner Note - Depreciation P 46

- Basis for depreciation – FMV on date of death or alternate valuation date
- Adjusted basis – FMV at alternate valuation date LESS depreciation allowed or allowable from date of death
- Rev. Rul. 63-223, 1963-2 C.B. 100

# Property Acquired from Decedent PP 46-47

1. Property acquired by bequest, devise, inheritance, or by decedent’s estate
2. Property transferred during decedent’s lifetime to revocable trust that pays income for life to or on the order of decedent
3. Property transferred during decedent’s lifetime to trust that pay income for life to or on the order of decedent AND decedent reserved right to make changes
4. Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will

# Property Acquired from Decedent PP 46-47

5. Surviving spouse's one-half share of community property held by decedent and surviving spouse
6. Property acquired from decedent after death and included in gross estate
7. Property includable under §2044 – claimed marital deduction

# A-B Trust Planning – Basis P 47

- Older plans – A-B or A-B-C trust estate plans
  - May not be necessary to reduce estate tax because $ 12,060,000 exclusion
  - 2026 change -- $ 5,000,000 (indexed for inflation) exclusion
  - No basis adjustment for assets in the B trust (credit shelter) because don't pass from the decedent

**FIGURE 2.1**
**Basic Exclusion Amounts**

| Year of Death | Exclusion Amount |
|---|---|
| 2004–2005 | $1,500,000 |
| 2006–2008 | $2,000,000 |
| 2009 | $3,500,000 |
| 2010–2011 | $5,000,000 |
| 2012 | $5,120,000 |
| 2013 | $5,250,000 |
| 2014 | $5,340,000 |
| 2015 | $5,430,000 |
| 2016 | $5,450,000 |
| 2017 | $5,490,000 |
| 2018 | $11,180,000 |
| 2019 | $11,400,000 |
| 2020 | $11,580,000 |
| 2021 | $11,700,000 |
| 2022 | $12,060,000 |

# Planning under Current Law P 48

- All assets go outright to surviving spouse
- Surviving spouse can get the deceased spousal unused exclusion (DSUE)
- There is a full step-up basis of appreciated assets

# Portability P 49

- Practitioner Note – Portability is an ELECTION
- Appreciation on deceased spouse’s assets included in surviving spouses' estate
- Credit shelter trust may still be useful if estates do or could exceed combined exclusions

# Example 2.1 – Trust Planning P 49

- Alice & Tom are married with two kids from Alice's prior marriage
- Alice wants assets available to Tom, then distributed to the kids
- Alice dies in 2026  Tom survives her
- Alice's gross estate is $8M (assume the exclusion is $6M)
- Tom has $2M gross estate
- Credit shelter trust – receives $6 million for Tom's benefit,
- Marital Trust receives $2,000,000

# Example 2.1 Trust Planning

- Executor makes a QTIP election
- Alice's estate has no estate tax liability
- Tom dies
- All assets have appreciated
- Alice's children Credit Shelter Trust assets have a basis on Alice's date of Death
- Tom estate receives a Step-Up basis at his date of death

# Example 2.1 Trust Planning

Executor Does Not make QTIP election

Elects Portability

All Alice's assets get included in Tom's estate

$6 Million and Tom's basic exclusion and No Tax on Tom's death

Alice's children receive full step up in basis

# Uniformity of Basis P 50

- Property included in gross estate and increased estate tax
- Basis cannot exceed determined/reported value for federal estate tax
- Executor provides info to beneficiaries

# Uniformity of Basis

Executors' responsibilities

Provide information to the IRS

Provide information to each person receiving property

Information must be about valuation of property

Form 8971 information regarding beneficiaries acquiring property from a decedent

Report final estate tax values

Basis of property decedent acquires

# Uniformity of Basis P 50

Form 8971 is NOT required if:

Gross Estate + Adjusted Taxable Gifts < Basic Exclusion

or

Return filed only for GSTT exemption allocation

or

Return filed only for portability election

# Uniformity of Basis P 50

- Under proposed regulations, don't have to report:
  1. Cash (other than coins or paper bills with numismatic value)
  2. Income in respect of a decedent
  3. Items of tangible personal property for which an appraisal is not required
  4. Property that is sold or otherwise disposed of by the estate (and therefore not distributed to a beneficiary) in a transaction in which capital gain or loss is recognized

# Form 8971, Schedule A P 51

- ➢Provided to beneficiary
- ➢Establishes value
- ➢Notice of basis reporting requirements

**FIGURE 2.2**
**Form 8971, Schedule A, Part 2**

**Part 2. Information on Property Acquired**

| A<br>Item No. | B<br>Description of property acquired from the decedent and the Schedule and item number where reported on the decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. If the beneficiary acquired a partial interest in the property, indicate the interest acquired here. | C<br>Did this asset increase estate tax liability? *(Y/N)* | D<br>Valuation Date | E<br>Estate Tax Value *(in U.S. dollars)* |
|---|---|---|---|---|
| | Form 706, Schedule ______, Item ______<br>Description — | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |

**Notice to Beneficiaries:**

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

# Gifts within 1 Year of Death P 51

I.R.C. §1014(e) prevents step-up basis for predeath gifts

- Appreciated property gifted within 1 year of date of death
- Passes to the donor or donor's spouse
- Carryover basis

# Planning Pointer P 51

- I.R.C. §2518 – Qualified Disclaimer
- Property treated as not transferred to beneficiary
- Alternate beneficiary could receive step-up

# Example 2.2 P 52

- Lorenzo & Maria are married, daughters Luna & Bella
- Maria transfers appreciated shares to Lorenzo
- Lorenzo dies 6 months later
- Maria inherits everything – no step up in basis of shares
- Disclaim to kids

# Value on Date of Death P 52

FMV – date of death or alternate valuation date

- Willing buyer and willing seller
- NOT determined by forced sale
- Comparable price if in retail market

# Valuation on Date of Death P 52

- Auto – same make, model, age, condition - NOT used dealer
- Publicly Traded Stocks – highest & lowest quoted selling price
- Household & Personal Property
  - FMV – willing buyer/willing seller
  - Treas. Reg. 20.2031-6 – may need appraisal

# Jointly Owned Property P 52

Co-owned property included in gross estate, I.R.C. §2040 – exceptions

1. Tenancy by entirety - ½ of value included
2. Joint tenants with right of survivorship - fractional part that is determined by dividing the value by the number of joint tenants
3. Qualified joint Interest - ½ of value included

# Jointly Owned Property P 53

Non-spouses - I.R.C. §1014 step-up/step-down basis

# Example 2.3 P 53

- Ahmad & Cyril, brothers
- Purchased tract of land for $100,000
- Ahmad, contributed $70,000 and Cyril $30,000
- Ahmad dies, FMV of land $200,000
- $140,000 included in Ahmad's gross estate
- Cyril’s basis = $170,000 ($30,000 + $140,000)

# Noncommunity Property P 53

I.R.C. §2040(b) – interests held by married individuals

- Tenants by entirety
- Joint tenants with rights of survivorship
- First spouse dies – ½ of value included in gross estate
- I.R.C. §1014 – step-up/step-down on ½ interest

# Example 2.4 Joint Tenancy P 53

- Jeff & Kim, married Colorado residents
- 10 acres of land tenants by entirety
- Jeff $90,000/Kim $10,000
- Kim died, FMV is $200,000
- $100,000 included in Kim's estate
- Jeff's basis is $150,000 ($50,000 deemed basis + $100,000)

# Practitioner Note P 54

Depreciation Adjustments to Basis

- Surviving spouse reduces basis by proportionate share of depreciation deduction
- No reduction in basis if no depreciation benefit
- All income allocable to decedent spouse, no adjustment to basis
- Treas. Reg. 1.1014-6(a)

# Community Property P 54

- Each spouse treated as owning ½ of community property
- I.R.C. §1014(b)(6) basis of entire property step-up/step-down
- Practitioner Note – list of community property states

# Example 2.5 – Inherited Community Property

P 54

- Kerry & Jerry married CA residents
- $80,000 basis
- Jerry died FMV of property was $100,000
- $50,000 included in Jerry's estate
- Kerry's basis = $100,000

- Instead - MT
- Kerry's basis = $90,000 ($40,000 + $50,000)

# Planning Pointer P 54

Community Property Agreement

- ➢Acquisition from community property state
- ➢May retain character as community property

# Sale of Inherited Assets

# Capital Assets P 55

I.R.C. §1221 - All classes of property, with exclusions:

1. Stock in trade of the taxpayer or other property included in inventory, or property held primarily for sale to customers in the ordinary course of trade or business
2. Property used in taxpayers trade or business, that is depreciable under §167 or that is real property used in trade or business

# Exclusions Continued P 55

3. Accounts or notes receivable acquired in the ordinary course of trade or business for services or from the sale of property described in #1
4. Supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer

# Holding Period P 55

§1223(9)

Deemed more than 1 year

# Example 2.6 Short-Term Sale P 55

- Bryant & Shonda bought vacation home, $550,000
- Bryant died
- Shonda sold the home 6 months later
- Treated as held for more than 1 year
- Long-term capital gain

# Deductible Capital Loss P 56

I.R.C. §165 – no loss deduction on personal-use property

Individual losses limited to:

- Losses incurred in trade or business
- Losses incurred for-profit transactions
- Casualty & theft (with limits)

# *Marx v. Commissioner* P 56

- TP inherited yacht from husband
- Kept yacht in storage, then sold at a loss
- IRS denied loss
- Court upheld loss on the sale b/c not personal-use

# *Reynolds v. Commissioner* P 56

- TP inherited jewelry from his aunt
- Sold 10 pieces through an agent
- Claimed ordinary loss on the sale of diamond necklace
- IRS said nondeductible personal loss
- Court said capital asset & deductible capital loss

# Inherited Rental Property P 56

*Crawford v. Commissioner*

- TP inherited partial interest in personal residence
- She unsuccessfully tried to rent the house but lived there while remodeling a new home
- Sold the house at a loss
- Court found deductible ordinary loss on sale

# Inherited Rental Property P 56

*Balsamo v. Commissioner*

- TP inherited husband’s rental property
- Continue to lease it out under existing lease
- Sold at a loss
- Court found she performed no rental activity and capital loss

# Inherited Inventory P 57

Capital or ordinary determined in hands of recipient (not decedent)

*Estate of Ferber v. Commissioner*

- Decedent owned retail fur store
- Executors kept the store open while they liquidated & disposed of business
- Sold merchandise
- IRS said gain on sales was ordinary
- Court said sale of inventory by executors is capital gain

# Gifts in Contemplation of Death

# I.R.C. §2035 P 58

The decedent made a transfer of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death; AND

The value of such property (or an interest in the property) would have been included in the decedent's gross estate under

- 2036(transfers with retained life estate)
- 2037(transfers taking effect at death)
- 2038(revocable transfers)
- 2042(proceeds of life insurance)

if the decedent had retained such transferred interest or relinquished power on the date of death

# Example 2.7 – Gift of Life Insurance     P 58

- Gerald owned $1,000,000 life insurance policy
- Present value = $200,000
- Ownership transferred to irrevocable life insurance trust for daughter
- Gerald gifted $1,000,000 publicly traded stock to son
- Gerald died 2 years after the gifts
- Insurance policy included in gross estate
- Gifted stock not included in gross estate (but gift tax paid is included)

# Practitioner Note P 58

3-Year Transfers

Value of gross estate includes all transfers 3 years before death for the following purposes:

- I.R.C. 303(b) – distributions in stock redemption to pay tax
- I.R.C. 2032A – special valuation of certain farms & real property
- Chapter 64 subchapter C – lien for taxes

# §2035 Transfers P 58

- NOT included if no gift tax return
  - Annual gift tax exclusion
  - Exclusion for medical
  - Exclusion for tuition cost

# Practitioner Note – Annual Exclusion P 58

2022 annual gift tax exclusion

$16,000

Rev. Proc, 2021-45, 2021-48 I.R.B. 764

# Irrevocable Life Insurance Trusts

# Irrevocable Life Insurance Trust P 59

- Shelters proceeds from estate inclusion
- I.R.C. 2042 proceeds included in gross estate of decedent if ownership or incidents of ownership – include the power to do the following:
  1. Change the beneficiary
  2. Surrender or cancel the policy
  3. Assign the policy
  4. Revoke an assignment
  5. Pledge the policy for a loan
  6. Obtain from the insurer a loan against the surrender value of the policy

# Estate Inclusion P 59

Incidents of ownership also includes reversionary interest in policy or proceeds exceeding 5% of policy's value

Reversionary interest is the possibility the policy or its proceeds may return to decedent or the estate or become subject to a power of disposition by the decedent

# Structuring the Trust P 59

- Insured executes the trust Instrument to create the ILIT
- Insured assign insurance policy to the trust OR contributes cash and trustee buys an insurance policy
- Trustee is designated beneficiary of the policy
- At insured’s death, policy proceeds paid to the trust

# Example 2.8 Use of an ILIT P 60

- Charlotte has $14,000,000 gross estate
- $2,000,000 life insurance policy included, $300,000 present value
- Ownership of life insurance transferred to ILIT
- Nieces & Nephews are beneficiaries
- Gross estate now $12,000,000
- Applicable exclusion $12,200,000
- Saves approximately $600,000 estate tax

# Gift Tax on Contribution to ILIT P 60

- Contribution of cash is a gift
  - $16,000 gift tax exclusion if present interest
- Transfer of an existing policy will not qualify for the annual exclusion unless the beneficiary has a present interest
- Present interest is unrestricted right to immediate use, possession, or enjoyment

# Example 2.9 No Annual Exclusion P 60

- Taylor transferred insurance policies to trust
- Beneficiary is son, Ben
- Payments to Ben commence only after Taylor
- Future interest gift – does not qualify for gift tax annual exclusion

# Gift Tax on Payment of Premiums P 60

- Insured typically pays policy premiums
- If beneficiary has power to withdraw – gift tax exclusion may apply
  - *Crummey v. Commissioner* – parents created trust for 4 four kids, sought to deduct annual exclusion amount for contribution to trust. Trust gave kids right to demand distributions. Court upheld annual exclusions.

# Withdrawal Rights P 61

Crummey withdrawal right is a general power of appointment

- Non-exercise of withdrawal right is a lapse (deemed gift) to the extent that it exceeds the greater of $5,000 or 5% of the trust value
- Thus, many ILITS contain this 5 X 5 limitation

# Qualified Personal Residence Trusts

# QPRT P 62

- Grantor reserves the use of residence for specified term of years
- End of term, residences pass to grantor’s children or beneficiaries
- Value of gift to trust = value of remainder interest
- Removes appreciation on residence from grantor’s gross estate

# Valuing the Gift P 62

I.R.C. §7520 actuarial tables to determine value of retained interest

- When 7520 is low, value of remainder interest is high
- Preferable to establish QPRT when rate is high, and value of gift is low
- Longer the term, less the gift amount will be
- If donor dies during term, QPRT’s assets included in donors' gross estate

# Example 2.10 Calculating the Remainder Gift P 62

- Miguel purchased vacation home for Gabriela
- FMV = $1,200,000
- Miguel is age 55
- §7520 rate is 2%
- Gift to QPRT 10-year term

- Remainder value of gift is $870,209
- If §7520 rate was 6% remainder value of gift would be $604,052

# Requirements for a QPRT P 63

- Treas. Reg. 25.2702-5(b) – prohibits trust from holding any asset other than one residence
- Must be used personally by term holder
- 2 years – reinvest proceeds from damage, destruction, or involuntary conversion

# Example 2.11 Rental of Residence P 64

- Lawrence owns vacation condo
- Rents it for 180 days
- He occupies it for more than 18 days each year
- Provides no substantial services to renter
- Retains lifetime right to use
- Qualifies as QPRT

# Example 2.12  Temporary Absence      P 64

- Bryan – QPRT with 10-year term
- He moves to nursing home
- Wife remains in personal residence
- Residence still available for Brian’s use (even if not used)
- Qualifies as QPRT
- If trustee rented home to unrelated party –disqualified

# QPRT Requirements Continued P 64

- Prohibit sale or transfer of the residence directly or indirectly to grantor or grantor's spouse
- If grantor dies during term, trust distributes residence
- Term end – can distribute to grantor's spouse with no consideration

# QPRT Requirements Continued P 64

**Personal Residence**

- The principal residence of the term holder
- One other residence of the term holder
- An undivided fractional interest in either

**Additional Property Can Include**

- Appurtenant residential structures
- Adjacent land

NOT personal property

# Example 2.13 Trust Holds Other Assets P 64

- Wanda owns 200-acre farm
- Farm includes – house, barns, equipment buildings, silo, and enclosures for confinement of farm animals
- Transfers to irrevocable trust
- Retained use for 20 years and remainder interest to her son
- NOT a QPRT because farm assets don’t meet requirements for personal residence

# Example 2.14 Personal Property P 65

- Valery transferred principal residence to irrevocable trust
- Retained right to use for 20 years
- Trust does not prohibit holding personal property
- NOT a QPRT

# Secondary Business Use P 65

- Primary use - occupied by term holder as residence
- Secondary use of a portion is okay
  - Business (home office)
  - Day care

# Example 2.15 Incidental Business Use P 65

- Charlotte maintains personal residence
- One room is principal place of business
- Personal residence qualifies

# QPRT Terms P 65

1. Any income of the trust must be distributed to the term holder not less frequently than annually.
2. There can be no distributions of corpus to any beneficiary other than the transferor during the retained term interest.
3. The trust, with some exceptions, cannot hold any asset other than one residence to be used or held for use as a personal residence of the term holder. Special rules apply if the trust ceases to be a QPRT (see 6)

# QPRT Terms P 65

4. The governing instrument must prohibit commutation (prepayment) of the term holder’s interest.
5. The governing instrument must provide that a trust ceases to be a QPRT if the residence ceases to be used or held for use as a personal residence of the term holder or upon a sale of the residence if the governing instrument does not permit the trust to hold proceeds of sale of the residence.

# QPRT Terms PP 65 - 66

If the governing instrument permits that trust to hold sale proceeds, the governing instrument must provide that the trust ceases to be a QPRT with respect to all proceeds of sale held by the trust upon the earlier of:

a) The date that is 2 years after the date of sale

b) The termination of the term holder's interest in the trust OR

c) The date on which the trust acquires a new residence

# QPRT Terms P 66

6. The governing instrument must provide that, within 30 days after the date that the trust has ceased to be a QPRT
   a) The assets are distributed outright to the term holder OR
   b) The assets are converted to and held for the remainder of the term in a separate share of the trust that meets the requirements of a qualified annuity interest

# QPRT Terms P 66

7. The governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust, or at any time after the retained term interest that the trust is a grantor trust

# Permissible Trust Assets P 66

Cash can be used for

1. Payment of trust expenses – up to 6 months
2. Improvements to the residents – up to 6 months
3. Purchase of initial residence – within 3 months of trust creation
4. Purchase of replacement residence – within 3months
5. Additions of cash – quarterly

Distribute all excess

Practitioner Note – after trust term grantor option to lease back

# Sample QPRT P 66

Rev. Proc. 2003-42, 2003-1 C.B. 993

# Gift & Estate Tax on 529 Plans

# I.R.C. §529 Qualified Tuition Plan P 68

- Contributions not taxable income of the beneficiary
- Qualified distributions are not taxable
- Certain distributions or changes may be a taxable gift
- Amounts distributed on account of death of designated beneficiary are subject to estate tax

# Gift Tax – Rollovers P 68

No taxable gift if roll over w/in 60 days to QTP for member of family same generation or higher

Member of the family

1. The spouse of the beneficiary
2. A qualifying relative (see list)
3. The spouse of any individual in 2
4. The first cousin of the beneficiary

# Gift Tax - Change in Designated Beneficiary PP 68-69

- Change beneficiary is not taxable gift if member of family and same generation or higher
- Taxable change is deemed distribution
- Example 2.16 -- Designating a New Beneficiary
  - Change to younger brother, same generation so no gift tax
- Planning Pointer – Successor Account Owner
  - Original owner can designate successor owner

# Estate Tax P 69

- General rule - no amount includable in gross estate
- Amounts distributed on account of death of designated beneficiary subject to estate tax (proposed regulations)
- Amounts included in estate of donor if dies within 5-year term for excess contributions

# Death of Designated Beneficiary PP 69-70

- Rule 1. Distribution to the estate of deceased beneficiary w/in 6 months is included
- Rule 2. Predeath designation of successor beneficiary who is member of family and same generation or higher, not included
- Rule 3. Post-death designation of successor beneficiary who is member of family and same generation or higher, not included
- Rule 4. Withdrawal by account owner not included (but income tax)
- Rule 5. No designated successor, not included (but income tax)

# Donor's Gross Estate P 70

- Contribution to 529 plan is completed gift
- Election to include over 5-years
- Dies within the 5-year term, contributions allocable to post-death are included in the donor's gross estate

# Example 2.17 – Excess Contributions PP 70-71

- Angela contributed $80,000 to 529 plan
- Elects to include ratably over 5 years
- Completed gift and qualifies for annual exclusion
- Angela dies in year 4
- $16,000 for year 5 included in her gross estate

# Questions?