

ST. MARY'S UNIVERSITY SCHOOL OF LAW

FEDERAL ESTATE AND GIFT TAX, LW8379
Professor Cochran

FINAL EXAMINATION
Fall Semester 1994

Instructions

1. This examination consists of two pages, plus this cover sheet. Please check to be sure you have all pages.
2. There are three questions, two of which have subparts. Please indicate clearly which question and which subpart you are addressing.
3. You will have three hours to complete this examination. A percentage allocation is provided for each question.
4. You may use your own copy of the Internal Revenue Code and Regulations annotated in your own handwriting. No other outside materials are permitted.
5. Please write legibly, skipping every other line.
6. St. Mary's University School of Law prohibits disclosure of information that might aid a professor in identifying the author of an examination. Any attempt by a student to identify himself or herself in an examination is a violation of this policy and of the Code of Student Conduct.
7. After reading the oath, place your exam number in the space below. If you are prevented by the oath from placing your exam number in the space below, notify the proctor of your reason when you turn in the examination.

**I HAVE NEITHER GIVEN NOR RECEIVED UNAUTHORIZED AID IN
TAKING THIS EXAMINATION, NOR HAVE I OBSERVED ANYONE
ELSE DOING SO.**

EXAM NUMBER

QUESTION ONE
60 percent

Father, an unmarried individual, irrevocably transfers \$1 million worth of stocks and bonds to a trust in year one, naming himself trustee. The trust instrument names Daughter as successor trustee upon Father's death or resignation. The trust instrument provides for all income to be paid to Daughter for life, with the corpus to be paid to Grandson (Daughter's son) at Daughter's death. When the trust is established in year one, Father is 85 years old, Daughter is 60 years old, and Grandson is 30 years old. (To the extent that actuarial calculations are necessary on any part of this examination, you should assume that the applicable interest rate is eight percent.) Father dies in year six, when the corpus of the trust is worth \$6 million. Daughter dies in year ten, when the corpus of the trust is worth \$10 million.

A. Please discuss the federal estate, gift, and generation skipping transfer tax consequences of the events described above.

B. How does your answer change if the trust instrument gives the trustee the unrestricted power to accumulate income instead of distributing it to Daughter? (You may assume that the power is never exercised.)

C. How does your answer change if, instead of the power described in Part B, the trust instrument gives the trustee the unrestricted power to invade corpus for Daughter's benefit? (You may assume that the power is never exercised.)

D. How does your answer in part C change if Father resigns as trustee in year two, when the corpus of the trust is worth \$2 million?

E. How does your answer in part C change if Father resigns as trustee in year four, when the corpus of the trust is worth \$4 million?

QUESTION TWO
25 Percent

Grandmother, age 80, and Grandson, age 30, purchase a commercial building for \$1 million. Pursuant to their instructions, the seller conveys a life estate to Grandmother and the remainder to Grandson. When Grandmother dies ten years later, the building is worth \$2 million.

A. Please discuss the federal estate, gift, and generation skipping transfer tax consequences if Grandmother pays the entire \$1 million purchase price herself.

B. How does your answer change if Grandson pays a portion of the purchase price equal to the actuarial value of his remainder interest as of the date of sale (\$586,320 according to your humble professor's calculations), and Grandmother pays the balance of the purchase price?

QUESTION THREE
15 Percent

Husband and Wife, both age 70, have no children. Neither of them has made any taxable gifts. Husband dies, leaving his entire estate in trust. The trust provides that all trust income is to be paid to Wife for life. Upon Wife's death, the trust corpus is to be distributed to the Salvation Army. Husband's estate, net of funeral and administrative expenses, is \$1,200,000. When Wife dies ten years later, the trust corpus is worth \$2,000,000.

Please discuss the federal estate tax consequences at each spouse's death.

MODEL ANSWER

QUESTION ONE

Part A.

1. Estate Tax -- No consequences at Father's death. He holds no interest other than as trustee. Also no estate tax consequences at Daughter's death because she is merely a life tenant (and trustee) and owns nothing at death.

2. Gift Tax -- Father has made a completed gift of \$1 million. The gift to Daughter is a gift of a present interest, so one \$10,000 exclusion is available. No exclusion applies to the gift to Grandson, since his remainder is a future interest.

3. GST Tax -- A taxable termination occurs at Daughter's death. The Taxable Amount is \$10,000,000. We don't know the inclusion ratio because we don't know how much exemption, if any, was allocated to the original transfer. If Father's entire \$1 million exemption was allocated to the trust at the time it was established, the applicable fraction would be 1/1, the inclusion ratio would be zero, and there would be no tax. We haven't been told whether such an allocation was made.

Part B.

1. Estate Tax -- Father has retained a 2038 power--the power to take income away from Daughter and accumulate it for Grandson. This would cause the value of Daughter's income interest as of the date of Father's death to be included in Father's gross estate. Father has also retained a power described in section 2036, however, since he has the right to designate who shall enjoy the income from the property. This brings in the entire corpus (\$6,000,000). Nothing is included

in Daughter's estate. As trustee, she has the power to accumulate income, but this adds nothing to her interest as life income beneficiary (she can give the income she receives to Grandson anyway). Since she didn't exercise the power (which would potentially invoke section 2036), nothing is included.

2. Gift Tax -- Since Father has the power to take away Daughter's income interest and give it to Grandson, there is a completed gift only of Grandson's remainder interest. No annual exclusion is available since it is a future interest.

3. GST Tax -- There is a Taxable Termination at Daughter's death, as in part A. Here, however, since Father retained a 2036 power, it seems logical that the transfer to the trust for purposes of allocating the exemption should be treated as occurring at Father's death. This is confirmed by section 2642(f), which "holds open" the transfer until Father's death. Thus, if all of Father's exemption is allocated to this trust, it will only cover 1/6 of the corpus.

Part C.

1. Gift -- Father has made a complete gift of the income interest to Daughter, which qualifies for the \$10,000 annual exclusion. (The amount of the gift is the actuarial value of Daughter's income interest less the exclusion.) There is no completed gift of Grandson's remainder, since Father can take it away and give it to Daughter.

2. Estate -- Father has retained control over the remainder, so it's value will be included in his gross estate under section 2038. For purposes of section 2036, Father has retained the power to designate who shall possess or enjoy the property, but 2036 should not be read to bring in the value of Daughter's income interest, which Father cannot take away. Thus, under 2036 or 2038, the appropriate inclusion in Father's gross estate is the value of

Grandson's remainder interest as of the date of Father's death. The entire value of the corpus will be included in Daughter's gross estate since she holds a general power of appointment.

3. GST Tax -- The GST tax does not apply at Daughter's death because the trust is included in her gross estate. Thus, there's no need for the GST (and the "bump down" provision applies to eliminate the generation skip).

Part D.

1. Gift Tax -- When Father resigns, he is making a completed gift of the remainder to Daughter (since she holds the power to claim it). The amount of the gift is the actuarial value of the remainder on the date of Father's resignation, reduced by the \$10,000 exclusion. The exclusion is available because Daughter's power of appointment is equivalent to a "Crummey power."

2. Nothing is included in Father's gross estate because he has given everything away and retains no strings. The entire trust (\$10,000,000) is included in Daughter's gross estate because she holds a general power of appointment.

3. As in part C, the inclusion of the trust in Daughter's gross estate results in a "bump down," so the GST does not apply at Daughter's death.

Part E

1. Gift Tax -- As above, Father's resignation results in a completed gift of the remainder.

2. Estate Tax -- Since Father died within three years of relinquishing his 2036/2038 powers, the relinquishment is effectively nullified by section 2035. Thus, Grandson's remainder will be brought into

Father's gross estate at its value on the date of Father's death. (The mechanics of section 2001 will result in an offset for the amount already taxed as a gift, so that only the appreciation since the date of the gift will be taxed at Father's death.) Once again, the entire trust will be included in Daughter's gross estate at its value on the date of her death, because she holds a general power of appointment.

3. Again, the GST Tax does not apply at Daughter's death because of the "bump down."

QUESTION II

Part A.

Grandmother is making a gift of the remainder to Grandson. The actuarial value of the remainder is \$586,320, but section 2702 says we must value Grandmother's retained life estate at zero for gift tax purposes. Thus, Grandmother makes a \$1,000,000 gift.

Since Grandmother has given away a remainder and retained a life estate, the property will be included in her gross estate at its date of death value of \$2,000,000 (with an offset for the lifetime gift under section 2001).

Unless Grandson's parents are deceased, the gift of the remainder is a generation skipping transfer. Since Grandmother is deemed to retain ownership of the property for estate tax purposes, it makes sense that the GST exemption should not be allocated until her death. Section 2642(f) confirms this. Thus, at most half of the value of the property will be covered by the exemption. This transfer appears to meet the definition of a taxable termination and a direct skip. The direct skip should take priority, since the transfer is subject to estate tax at the same time. This means that it will be a tax-exclusive transfer (i.e., the taxable amount will be the net amount received rather than the gross amount of the property).

Part B

If Grandson pays for his interest, section 2702 will treat Grandmother as making a gift of the \$1 million value of the property minus the consideration paid by Grandson.

The value of the property should not be brought

into Grandmother's estate by section 2036 because 2036 contains an exception for transfers for adequate consideration (and section 2702 applies only for gift tax purposes).

This should not be a GST because it is not a gratuitous transfer (other than per section 2702). Section 2624(d) seems to support this result.

QUESTION III

At husband's death, there will be no charitable deduction because the charity's remainder is not a qualified interest (the trust is not a CRAT or a CRUT). The Wife's life estate is a terminable interest, which will not support a marital deduction unless a QTIP election is made. If a QTIP election is made, which will almost certainly be the case absent malpractice, there will be no tax at Husband's death. (Depending on the size of Wife's separate estate, it might be wise to elect QTIP for only \$600,000 of the trust, since the other \$600,000 is covered by the unified credit anyway. This is relevant only in that it makes Wife's gross estate smaller, which might be significant for some other reason such as section 303 or 6166 or 2032A.)

At Wife's death, the trust will be included in her gross estate to the extent that Husband's executor made a QTIP election. A charitable deduction of equal amount will be allowed. Thus, the trust will effectively pass without tax at Wife's death.