Acc. 433, Chapter Outline for use with Prentice Hall's Federal Taxation Corporations
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Test 3

12) The Gift Tax

- **a) This is a transfer tax. A tax on the "privilege" of giving your money away.**
- **b) Recipient does not have any tax liability**
- **c) This is a unified tax with the estate tax**
- **d) Progressive tax rates maxing out at 55% now down to 35% on amounts over $5,000,000**
- **e) A unified credit offsets the tax on taxable gifts and transfers at death up to the first $5,000,000 (2011) $5,120,000 (2012)**
- **f) The unified credit goes to an equivalent of taxable gifts of $5,000,000**
- **g) What is a gift?**
  - **i) Unlimited marital deduction (can give anything to a spouse without a tax**
  - **ii) Gift splitting -**
    - ***(1) Election required***
    - ***(2) Gift by one spouse is treated as given equally by both***

h) Tax is on cumulative lifetime and death transfers (not yearly)
i) A gift is a transfer for less than adequate and full consideration in money or money's worth. Gifts are of property, not services
j) Bargain sales to family or friends are partial gifts
k) Exemptions
  i) Direct payment of tuition
  ii) Direct payment of medical expense
  iii) Support (legally required)
  iv) Political gifts (but not for estate tax)
  v) Payments as part of a divorce
l) Qualified disclaimers
  i) If you are supposed to inherit and you refuse to take, then it is really a gift to those who receive the inheritance, unless
  ii) Irrevocable disclaimer, in writing
  iii) Within nine months of the transfer
  iv) Can't accept any benefit from the property
  v) Property passes without any direction by the disclaimant
m) A gift only occurs when the donee parts with dominion and control
  i) Revocable trusts are therefore not gifts, until they become irrevocable
  ii) Even irrevocable trusts are not gifts if the donor retains control
n) Valuing Gifts
  i) FMV at the time of the gift
  ii) FMV = Willing buyer and willing seller price
  iii) One can retain a life estate and transfer the remainder, with only the remainder being a gift
o) Joint tenancy bank accounts
  i) Goes to the survivor at death
  ii) Gift when funds are withdrawn in excess of the contribution
p) Other Joint Tenancy Property are gifts when set up (of 1/2)
q) Insurance
  i) Just naming a beneficiary is not a gift, if the owner can change beneficiaries
  ii) If existing policy is transferred, FMV is cost of a similar policy
r) General Power of Appointment
  i) Exists if one has a power to appoint to himself, his creditors, her estate or the creditors of her estate
  ii) A gift exists when the power is exercised in favor of someone else (thus giving your money away)
  iii) Exercising a limited power of appointment is not a gift
s) Net gifts - FMV less gift tax paid by donee
t) Annual Exclusions - $13,000 per year only for gift tax
  i) per donee
  ii) per year
  iii) present interest only
  iv) For child, if receives by age 21
  v) Crummey trust (has one month to take it)
u) Marital deduction is unlimited in amount!
  i) Outright to spouse
  ii) Can not be a terminable interest, unless it is Qualified
v) QTIP - Qualified Terminable Interest Property
  i) To spouse

(1) ***Income for life at least annually***
(2) ***No one other than spouse can receive distributions***
(3) ***(Not in book) spouse must be able to demand the property is income producing***
(4) ***Elect it for gift tax or estate tax***

ii) Effect is to give a gift tax marital deduction
(1) Effect of election is to treat it as the spouses property

iii) ***At spouse's death, the grantor can name the remainder beneficiary***

w) **Charitable contributions are allowed in any amount**
i) **Split interests gifts are allowed to charity**
ii) ***Such as a remainder interest***
(1) ***Done in order to get a present income tax deduction***
(2) ***Done in order to have any gains on sale of trusts assets avoid present income tax***

x) **Determining gift tax liability**
i) **It is a cumulative tax**
ii) **Add current gift to all future (taxable) gifts**
iii) **Determine the tax - tax on prior years gifts = net tax**

y) **Unified Credit**
i) **No tax for 2011 $5,000,000 equivalent = $1,730,800 credit**
ii) **No tax for 2012 $5,120,000 equivalent = $1,772,800 credit**
iii) **2010 (can elect for 2011 deaths) $5,000,000 is the exemption equivalent (no tax). Tax exceeding that amount = 35%**

z) **Basis of property received by gift**
i) **Lower of FMV or Adjusted Basis at time of gift + % gift tax**
ii) **Adjustment for gift tax paid is based on gift to related to appreciation only**
(1) ***Gift Tax X (appreciation/FMV less exclusions or deductions)***
(2) ***Can not exceed FMV***

aa) **Below Market Loans (Interest Free Loans) Very complicated!**
i) **Treats the transaction as a fiction in which interest is actually paid in an amount equal to the correct interest rate, less the amount actually paid**
ii) **For family members**
(1) ***Treats borrower as paying interest***
(2) ***Treats lender as making a gift of the interest to the borrower***
(3) ***Net effect***
(a) Borrower - Interest expense (may be deductible)
(b) Lender - Gift + Interest income
(4) ***Exceptions:***
(a) Less than $10,000 loans (combined)
(b) Less than $100,000 and borrowers investments income is less than $1,000

bb) **Filing requirements**
i) **Form 709**
ii) **Annual tax return, due April 15th**
iii) **Penalty for undervaluing gifts (even if appraisal)**
(1) ***Reported amount is 25% but less than 50% of real value = 20%***
(2) ***Reported amount is less than 25% of the real value = 40%***

- *cc) Statute of limitations*
  - **i) Three years if return is filed and adequate disclosure of the item is present**
  - **ii) Six years if more than 25% understatement of value**

13) The Estate Tax

- **a) No tax for 2011 $5,000,000 equivalent = $1,730,800 credit, excess taxed at 35%**
- **b) No tax for 2012 $5,120,000 equivalent = $1,772,800 credit, excess taxed at 35%**
- **c) $5,000,000 credit equivalent can be passed on to spouse = $10,000,000)**
- **d) Same as gift tax limits. Tax on excess = 35% $5,120,000 for 2011.**
  - **i) Tax on transferring property at death - Includes all assets, including ones not even owned by the decedent**
  - **ii) Unified credit applied to taxable estate**
    - **(1) Imposed after taking into consideration lifetime gifts - Add adjusted taxable gifts**
    - **(2) Is a net tax, thus some expenses, debts reduce the taxable estate**
    - **(3) Tax and credits, see gift tax above**
  - **iii) Value**
    - **(1) Generally fair market value, date of death**
      - ***(a) Life insurance on decedent is valued at the policy amount***
      - ***(b) Listed stocks equal to average of the high and low for the day, if weekend, average of high and low on Friday and Monday***
      - ***(c) Discount from FMV may be allowed for minority interest in closely held company***
      - ***(d) Real estate - FMV (no deduction for possible sales commissions)***
    - **(2) Alternative Valuation Date may be elected**
      - ***(a) Six months after death***
      - ***(b) If property is distributed or sold within the six months, then the value is as of the date of sale or distribution***
      - ***(c) Can be elected only if:***
        - (i) The gross estate is reduced, and
        - (ii) The tax is reduced
- **e) Specific Property**
  - **i) Family Owned Business = $1,300,000 less the credit equivalent (650,000)**
  - **ii) Property in which decedent had an interest (§2033)**
    - ***(1) All property owned***
    - ***(2) Includes cars, jewelry, stocks, houses, insurance, etc.***
    - ***(3) Included property in U.S. or foreign property***
  - **iii) Dower or courtesy rights (marital rights)**
- **f) Transfers by the decedent during life (§2035 - 2038)**
  - **i) Gifts within 3 years of death (gifts in contemplation of death)**
    - ***(1) Generally FMV at time of gift***
    - ***(2) If a life insurance policy, then value of the policy***
    - ***(3) Gift tax gross up - gift tax paid on gift is included in gross estate***
      - ***(a) Example: Suppose $1,000,000 cash gift two years before death, with $150,000 gift tax, then***
        - **(i) $150,000 is brought back into the estate**
  - **ii) Retained life estate - if decedent transferred the interest but retains an interest during lifetime, the whole value is included in the gross estate**
    - ***(1) Can include income interest retained (possession or enjoyment)***
    - ***(2) Includes simply the power to designate who will enjoy the income***
    - ***(3) Retaining voting rights is enough to pull it back into the estate***

- ***(4) Lifetime retention also includes any period which does not, in fact, end before death***
- ***(5) Reversion to decedent is enough***
  - (a) If another person must survive him or her, and
  - (b) Decedent's reversionary interest is greater than 5%

- **iii) Revocable transfers are included in the estate**
  - ***(1) Because nothing has been given away if it can be revoked***
  - ***(2) Generally not a gift (except as transfers are made)***
  - ***(3) Typically used in Revocable Living Trusts***
  - ***(4) Also includes the right to designate beneficiaries or change them***
- **iv) Retirement benefits are included if they will continue after death**
- **v) Jointly owned property (see gift tax above)**
  - ***(1) Goes directly to survivor!***
  - ***(2) If to spouse, then 1/2 in the estate, but an offsetting marital deduction***
  - ***(3) If to others, than the amount included in the estate is equal to 100%, unless it can be proved how much the survivor contributed***

g) Trusts set up by someone other than decedents may be included in decedent' estate if decedent had a general power of appointment (rather than special or limited power)

- **i) Defined as the power to appoint to self, estate, creditors, or creditors of the estate**
- **ii) Limited power is not included, such as the power to appoint among brothers and sisters (since decedent couldn't appoint to self)**

h) Life insurance on decedent is included at payout amount, if decedent had "incidence of ownership"

i) Possession of QTIP

- **i) If the decedent's spouse left the decedent (second to die) an interest for life and a QTIP election was made, the property is included in the second to die's estate at its then FMV**
- **ii) If no election was made, it is not included (which is the case for the trust with the exemption equivalent amount ($5,000,000)**

j) Deductions

- **i) Mortgages**
- **ii) Debts (master card, bank loans, etc.)**
- **iii) Final medical bills can be taken either on the final income tax return or on the estate tax return**
- **iv) Funeral bills can only be taken on the estate tax return**
- **v) Executor's and attorney's fees for administration**
- **vi) Final tax return amount due (if a refund, that is additional property)**

k) Losses - while the estate is being administered

- **i) Thefts, etc.**
- **ii) Can also sell stocks at a loss and take it**
- **iii) Must select whether to take the loss on the income tax return or on the estate tax return**

l) Charitable contributions are deductible up to 100% of the estate - must be reduced by any amount of the estate tax the charity must pay

m) Marital Deduction

- **i) Unlimited (up to 100% of the estate)**
- **ii) Must be outright transfer or QTIP election**
- **iii) May be by devise or bequest, dower or curtesy, joint tenancy, etc.**
- **iv) QTIP**
  - ***(1) Spouse receives all the income at least annually***

- ***(2) No person other than the spouse can appoint the property during the spouses life***
- ***(3) Election to treat as QTIP***
- ***(4) Spouse has the ability to make the property productive (in case the spouse is not the trustee - not in book)***
- ***(5) The effect of the election is to tax the value of the QTIP trust in the surviving spouse's estate when he/she dies***
  - (a) The value is added to the actual estate of the decedent
  - (b) The tax must be paid by the trust (at the highest marginal rates, unless elected otherwise)
- **(6) Typical QTIP: To my wife for life and then to my (our) children**
- **(7) Should probably leave the exemption amount without claiming the marital deduction by either**
  - ***(a) Giving that amount to someone other than the surviving spouse, or***
  - ***(b) Putting the property in trust for Spouse and not making a QTIP election***

n) Calculation

- **i) Add gross estate plus the adjusted taxable gifts to get the estate tax base**
- **ii) Calculate the tax – unified credit which offsets the tax up to $5,000,000 of value ($5,120,000 for 2011)**
- **iii) Subtract the amount of the gift tax (payable on the prior gifts)**
- **iv) Subtract the unified credit**
  - *(1) $1,772,800 2012*
  - *(2) $1,730,800 2011*
- **v) Subtract state death tax credit – no longer available. State death taxes are now deductible so that they reduce the taxable estate.**
- ***vi) Credit for multiple estates: If the same assets go through two estates, there can be two taxes.***
- ***vii) Credit reduces the effect***
  - ***(1) Essentially 100% credit 0-2 year, 80% 3-4, 60% 5-6 etc.***
- **viii) Foreign death tax credit for foreign property**

o) Deferral of tax if

- **i) Reasonable cause**
- **ii) Closely held business §6166**
  - ***(1) Included in the gross estate***
  - ***(2) Must be at least 35% of the adjusted gross estate***
  - ***(3) 15 or less owners of the business***
  - ***(4) Deferral is based on the tax owed on the business (pro-rated)***
  - ***(5) Interest only first 5 years***
  - ***(6) Tax and interest for next 10 years***
  - ***(7) (not in book) since the interest is a debt of the decedent, it is deductible, when paid, thus every year, you must amend the return to deduct the interest and recalculate the estate tax***

p) Redemption to pay death taxes

- ***i) Allows capital gains on the redemption***
- ***ii) Since stock is FMV date of death, little if any gain will result***
- ***iii) Stock must exceed 35% of adjusted gross estate***
- ***iv) Maximum amount of redemption =***
  - (1) Death taxes
  - (2) Funeral and administrative expense
    - ***(a) Can be redeemed even if the estate has adequate resources to pay the taxes and expense***

q) **Generation Skipping Transfer Tax (very complicated!)**
   i) **Purpose is to prevent avoiding a second estate tax by passing property directly to grandchildren or their equivalent**
   ii) **Tax is therefore 55% on such transfers (plus the original tax to the decedent)**
   iii) **Exemption = $5,000,000 per decedent**

r) **Compliance**
   i) **Due Date = 9 months after date of death**
   ii) **Up to six month extension (to file, not to pay)**
   iii) **Documents required**
      (1) Will
      (2) QTIP property
      (3) Appraisals for real estate
      (4) Life Insurance statement

14) **Income taxation of Trusts and Estates**

a) **Trusts**
   i) **Property is transferred into a trust to create the trust**
   ii) **Person funding the trust is the known by various names**

b) Grantor
   i) Settlor
   ii) Trustor

c) **If set up during life, it is a inter vivos trust**

d) **If set up at death, it is a testamentary trust**

e) **The property is know either as**
   i) Trust property
   ii) Trust res
   iii) Trust corpus

f) **A trust (unless a grantor trust) is a separate tax paying entity**

g) **Estates come into being if a decedent dies with property that need to be administered**
   i) **The person taking charge is the executor, if named in the will, or**
   ii) **The administrator, if appointed by a court**

h) **The estate is a separate taxpaying entity**

i) **Trusts can be created**
   i) **To manage property and distribute income**
   ii) **If revocable during life, not a taxpaying entity, but a legal entity**
   iii) These are set up for non tax reasons
   iv) Generally to avoid probate costs
   v) Property transfers at death to the named beneficiary or becomes part of a then irrevocable trust, terms as listed in the revocable trust

j) **Taxation of trust or estates is essentially the same**
   i) **They are taxpayers**
   ii) **Pay tax on taxable income**
   iii) **They receive a deduction for income distributed to a beneficiary**
      (1) Income only
      (2) Losses or deductions can not be distributed, although they can be netted against income
      (3) Thus, it is sort of a combination of partnership and corporate taxation, some income is taxed to the beneficiary (if distributed) and the rest is taxed to the trust

k) **Fiduciary Accounting! (debits and credits?)**
   i) **There are actually two income statements and balance sheets**
      (1) One for principal (corpus) - the property belonging to the trust

(2) One for income - the property (income) payable to a beneficiary

l) Trust Accounting Income TAI is a measuring stick of how much the beneficiary gets if the trust provides "All income for life to my spouse"
  - **i) What is income?**
    - ***(1) Interest***
    - ***(2) Dividends***
    - ***(3) Rents (net)***
    - ***(4) Interest expense***
  - **ii) What is principal – the original trust or estate property, plus**
    - ***(1) Capital gains***
    - ***(2) Capital losses***
    - ***(3) Taxes on capital gains***
    - ***(4) Amounts not distributed?***
  - **iii) What may be either?**
    - ***(1) Depreciation***
    - ***(2) Fiduciary expenses must be allocated***
  - **iv) Trust terms may override these general rules**

m) Calculation of DNI, Trust Accounting income, taxable income, etc.
  - **i) SEE APPENDIX II**
  - **ii) Trusts are entitled to a distribution deduction**
    - **(1) Depends on type of trusts**
    - **(2) Simple trust - all income**
      - ***(a) One that is required to distribute all income currently***
      - ***(b) No charitable beneficiary***
      - ***(c) $300 exemption***
      - ***(d) Taxable income is usually = Capital Gains - $300!***
    - **(3) Complex trust - income actually distributed, or**
      - ***(a) Income distributed with 65 days of year end for which an election is made***
      - ***(b) Any other trust that is not a simple trust***
      - ***(c) $100 exemption, or***
      - ***(d) $300 exemption if distributes all income***
  - **iii) Estates are entitled to a $600 exemption**

n) DNI
  - **i) Ceiling on which a beneficiary can be taxed, even if he/she receives more than that**
  - **ii) Also represents the maximum that the trust can deduct for payments to a beneficiary**
  - **iii) The character of the income passes through to the beneficiary**
    - ***(1) Interest is interest***
    - ***(2) Dividends are dividends***
    - ***(3) (netted by expense***
      - ***(a) Suppose $5,000 of dividends and $500 of tax return prep fees***
        - (i) Pass through is $4,500 (net)
        - (ii) There will be an AMT adjustment of $500
        - (iii) 2% misc. itemized reduction does not apply to those fees that only exist because this is a trust or estate, such as tax prep. fees
  - ***iv) Capital Gains are not included (unless part of income in the trust document)***
  - ***v) Major difference between DNI and TAI***
    - (1) Expenses chargeable to Corpus reduce DNI but don't reduce TAI
    - (2) Thus, if $5,000 interest and $500 state taxes
      - *(a) DNI = $4,500*

        (b) TAI = $5,000 (beneficiary gets $5,000 but pays tax on $4,500!)

o) Distributions of Principal are not taxable!
- **i) Suppose DNI = $5,000 and the trust says, give $100,000 to my son in 1999**
  - ***(1) Tax is on $5,000***
  - ***(2) The rest is simply as tax free distribution of Corpus***
- **ii) That is the same as if the father had died and left $100,000 in a bank account and in 1999 the son withdrew it (no tax on a withdrawal)**

p) Losses can not be passed out from a trust to a beneficiary
- **i) Exception in the final year**
- **ii) Capital losses also can not be passed out until the final year**

q) Beneficiaries pay tax on the amount received (limited to DNI)
- **i) In simple trusts = on current income even if they don't get it**
- **ii) In complex trusts only what they get or 65 day election**
- **iii) Exceptions:**
  - ***(1) Separate Share Rule - if it is really two trust, then it is treated that way***
  - ***(2) Specific Bequests are not taxable distributions, unless they for more than three distributions***
    - (a) Thus, gifts of a car or jewelry are not taxable
    - (b) Gifts of $100,000 are not taxable
    - (c) Gifts of $100,000 for five years is taxable, up to DNI each year

r) Income in Respect of a Decedent (IRD)
- **i) Amounts that would have been ordinary income or capital gain when (not if) received prior to death**
- **ii) Thus, no step up to fair market value date of death**
- **iii) Includes**
  - ***(1) Unpaid salary or bonus***
  - ***(2) Installment sale income***
  - ***(3) Accrued but unpaid interest***
  - ***(4) Declared but unpaid dividends***
- **iv) Thus, will be taxable to the trust, estate or beneficiary that receives it**

s) Grantor Trust Provisions
- **i) Effect of grantor trust status is that the income is taxed to the grantor, not to the beneficiary**
- **ii) Revocable trusts are grantor trusts**
- **iii) Trusts whose chances of reverting to the grantor exceed 5%**
- **iv) Retention of administrative powers by the grantor**
- **v) Retention of rights to income in grantor or spouse**
- **vi) Retention of control over others enjoyment**
- ***vii) Grantor's ability to pick between alternative beneficiaries***
  - ***(1) If only a trustee, it is ok to have those rights!***
  - ***(2) Grantor can keep the power to change trustees!***

t) Year Ends
- **i) Trusts - Calendar year**
- **ii) Estates - Fiscal year can be elected**
- **iii) Revocable living trusts may elect to be included with the estate and therefore pick a fiscal year, but there is only one combined tax return**

u) Due date = 15th day of fourth month (Estate = April 15th)

APPENDIX I

1. Basis (outside)	
2. Less: Cash distribution (or reduction in liabilities)	
3. If Negative = gain. If positive = remaining basis	
4. Less partnership's basis in distributed property (can not exceed basis in 3 above	
5. Remaining basis for adjustment for the partner's K-1 (share of income, loss etc.)r	

A. Liquidating

1. Basis (outside)	
2. Less: Cash distribution (or reduction in liabilities)	( )
3. If Negative = gain. If positive = remaining basis	
4. Less partnership's basis in distributed property: Inventory and Receivables only - Can not exceed partner's basis	( )
5. Remaining basis If no other property is received, then loss is recognized If other property is received, partner's basis is allocated to the property received based on partnership's relative basis	

APPENDIX II - Trust Taxation Chart

Trust	Simpl					
Item	Trust	Inco	Prin.	Alloc.	Tax	DNI
Dividends	30,00	YES			YES	YES
Rental	5,000	YES			YES	YES
Tax	15,00	YES		YES	NO	YES
Rental	(1,00	YES			YES	YES
Trustee's	(1,20	No	YES	YES	YES	YES
Tax return	(500)	YES	No		YES	YES
Capital	12,00		YES		YES	YES
Fed. Est.	(2,60		YES		NO	NO
Exemption					YES	YES
DNI						0
	-----	-----	-----	-----	-----	-----
Total	56,70					

Trust						
Simple				Alloc.	Tax	
Item	Trust	Inco	Prin.	Exem	Retur	DNI
Dividends	30,00	30,00			30,00	30,00
Rental	5,000	5,000			5,000	5,000
Tax	15,00	15,00		(360)		14,64
Rental	(1,00	(1,00			(1,00	(1,00
Trustee's	(1,20		(1,2	(360)	(840)	(840)
Tax return	(500)	(500)			(500)	(500)
Capital	12,00		12,0		12,00	0
Fed. Est.	(2,60		(2,6		0	0
Exemption					(300)	0
DNI					(32,6	0
	-----	-----	-----	-----	-----	-----
Total	56,70	48,50	8,20	(720)	11,70	47,30
Tax						(14,6

DNI						32,66

Updated as of 03/09/2011 – but only quickly. It is basically the 2008 version. Use at your own risk!