**Chapter 25**

**Transfer Taxes and Wealth Planning**

**SOLUTIONS MANUAL**

**Discussion Questions**

1. [LO 1] Identify the features common to the gift tax formula and the estate tax formula.

*The integration of the estate and gift taxes in 1976 provided for a cumulative progressive transfer tax rate schedule. In this integrated formula the cumulative effect of transfers in prior periods are taken into account when calculating the tax for a current gift or for the assets in an estate. The taxable gifts in prior years are added to the current transfer, and the tax is computed on total (cumulative) transfers. The tax on the earlier gifts is then subtracted from the total tax to prevent the earlier gifts from being taxed twice. The unified credit is a second common element that was designed to prevent taxation of all but the largest transfers. The amount of taxable transfers that can be made without exceeding the unified credit is referred to as the applicable exemption amount (previously the exemption equivalent). A final important feature of the unified taxes is the application of two common deductions. Each transfer tax provides for an unlimited deduction for charitable contributions and a generous deduction for transfers to a spouse (the marital deduction).*

2. [LO 1] Explain why Congress felt it necessary to enact a gift tax to complement the estate tax.

*Without a gift tax, the estate could be avoided by making intervivos gifts including deathbed transfers.*

3. [LO 1] Describe the unified credit and the purpose it serves in the gift and estate tax.

*The objective of the unified credit is to prevent the application of either the gift or estate tax to taxpayers who would not accumulate a relatively large amount of property transfers during their lifetime and/or would not have a relatively large value of assets to pass on to heirs upon their death. The amount of cumulative taxable transfers that can be made without exceeding the unified credit is referred to as the applicable exemption amount (previously the exemption equivalent) and as scheduled is $5.45 million for both the estate and gift taxes in 2016.*

4. [LO 1] Fred is retired and living on his pension. He has accumulated almost $1 million of property he would like to leave to his children. However, Fred is afraid much of his wealth will be eliminated by the federal estate tax. Explain whether this fear is well founded.

*The gift and estate taxes generally do not apply to taxpayers who have not accumulated a relatively large estate. Currently, the applicable exemption amount (previously the exemption equivalent) is set at $5.45 million for the estate tax. Fred’s pension will likely terminate at his death and will not be included in his estate. Hence, unless Fred has made significant taxable gifts during his life, he is unlikely to have an estate that is sufficiently large to be subjected to the federal estate tax.*

5. [LO 1] Define fair market value for transfer tax purposes.

*According to the regulations, fair market value is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both have reasonable knowledge of the relevant facts.*

6. [LO 2] Describe the requirements for a complete gift, and contrast a gift of a present interest with a gift of a future interest.

*A gift is only complete with delivery (of control of the gift) and acceptance by the donee. A present interest is one that the donee can enjoy immediately such as an unrestricted use of property or income. In contrast, a future interest is one that cannot be enjoyed immediately; the enjoyment is postponed until sometime in the future.*

7. [LO 2] Describe a property transfer or payment that is not, by definition, a transfer for inadequate consideration.

*A gift is defined as a transfer for inadequate consideration. The gift tax is not imposed on payments associated with sales of goods or services because these transfers occur in a business context where consideration (money) is exchanged for the goods or services. That is, there is adequate consideration. Neither is the satisfaction of an obligation considered a gift. For example, tuition payments for a child’s education would satisfy a support obligation and would not be considered a gift.*

8. [LO 2] Describe a situation in which a transfer of cash to a trust might be considered an incomplete gift.

*In some instances, a donor may relinquish some control over transferred property, but retain other powers to influence the enjoyment or disposition of the property. If the retained powers are important, then the transfer will not be a complete gift. For example, a transfer of property to a trust where the grantor retains the power to revoke the trust will not be a complete gift. In instances where the grantor retains important powers, the gift will generally be complete once the powers are released or the property is no longer subject to the donor’s control. For example, a distribution of property from a revocable trust will be a completed gift because the grantor would no longer have the ability to revoke the distribution.*

9. [LO 2] Identify two types of transfers for inadequate consideration that are specifically excluded from imposition of the gift tax.

*Political contributions are specifically excluded from the gift tax as are the payment of medical or educational expenses on behalf of an unrelated individual. To avoid confusing a division of property with a gift, a transfer of property in conjunction with a divorce is treated as nongratuitious (e.g., a transfer for consideration) if the property is transferred within three years of the divorce under a written property settlement.*

10. [LO 2] Under what circumstances will a deposit of cash to a bank account held in joint tenancy be considered a completed gift?

*A deposit to a joint account is viewed as an incomplete gift until the donee withdraws cash from the account because the donor (depositor) can withdraw the deposit at any time.*

11. [LO 2] Explain how a purchase of realty could result in a taxable gift.

*A completed gift results when realty is purchased in the name of a donee as sole owner of the property, as tenants in common, or as joint tenants with the right of survivorship if the donee does not provide adequate consideration for their ownership interest.*

12. [LO 2] Describe the conditions for using the annual exclusion to offset an otherwise taxable transfer.

*The annual exclusion can only offset a gift of present interest. A gift of a future interest is not eligible for an annual exclusion. The only exception is a transfer in trust for a minor (under age 21) where the property can be used to support the minor and any remaining property is distributed once the child reaches age 21.*

13. [LO 2] List the conditions for making an election to split gifts.

*In order to utilize gift splitting, each spouse must be a citizen or resident of the United States, be married at the time of the gift and not remarry during the remainder of the calendar year. In addition, both spouses must consent to the election by filing a timely gift tax return.*

14. [LO 2] Describe the limitations on the deduction of transfers to charity.

*As long as a qualifying charity receives the donor’s entire interest in the property, the amount of the charitable deduction is only limited to the value of the gift after the annual exclusion.*

15. [LO 2] Explain the purpose of adding prior taxable gifts to current taxable gifts and show whether these prior gifts could be taxed multiple times over the years.

*With a progressive tax rate schedule, adding to the tax base increases the likelihood that a higher marginal tax rate will apply to the latest increment (transfer). To prevent double taxation of prior gifts, the gift tax on prior taxable gifts is subtracted from the total gift tax.*

16. [LO 3] Explain why the gross estate includes the value of certain property transferred by the decedent at death, such as property held in joint tenancy with the right of survivorship, even though this property is not subject to probate.

*The gross estate includes testamentary transfers even though this property is transferred outside of the probate court (automatically through operation of law). While he didn’t “own” the property at death, the decedent had control of the ultimate disposition of the property.*

17. [LO 3] Identify the factors that determine the proportion of the value of property held in joint tenancy with the right of survivorship that will be included in a decedent’s gross estate.

*The amount includible for property held as joint tenancy with the right of survivorship depends upon the marital status of the owners. For property jointly owned by a husband and wife with the right of survivorship, half of the value of the property is automatically included in the estate of the first spouse to die. For other property held in joint tenancy with the right of survivorship by unmarried co-owners, the proportion of the value included in the decedent’s gross estate is the proportion of the consideration that the decedent provided to acquire the property. In the extreme cases, the entire value of property is included in the gross estate (where the decedent provided the entire purchase price of the property) or none of the value (where the decedent didn’t provide any of the consideration for the purchase).*

18. [LO 3] {Research} Harold owns a condo in Hawaii that he plans on using for the rest of his life. However, to ensure his sister Maude will own the property after his death, Harold deeded the remainder of the property to her. He signed the deed transferring the remainder in July 2009 when the condo was worth $250,000 and his life estate was worth $75,000. In January of this year Harold died, at which time the condo was worth $300,000. What amount, if any, is included in Harold’s gross estate? Explain.

*The value of the condo at the time of Harold’s death, $300,000, is included in his estate under Section 2036 and Reg. Section 20.2036-1(b)(2).*

19. [LO 3] Paul is a widower with several grown children. He is considering transferring his residence into a trust for his children and retaining a life estate in it. Comment on whether this plan will prevent the value of the home from being included in Paul’s gross estate when he dies.

*The value of the residence will still be included in Paul’s gross estate. Property transferred before the death of the decedent where the decedent retained an interest or a power is also specifically included in the gross estate.*

20. [LO 3] Explain how a remainder and an income interest are valued for transfer tax purposes.

*A remainder interest is essentially a promise of a future payment (upon the expiration of the temporary interest). As such, the value of the future payment can be estimated with a present value. For example, suppose that property worth $100 is placed in a trust with the income to be paid each year for 10 years after which time the principal (corpus) of the trust will be distributed. In such an instance, the remainder is estimated by the present value of a payment of $100 in 10 years as follows:*

*Remainder interest = future payment / (1 + r) n*

*Where r is the market rate of interest and n is the number of years. The interest rate for this calculation is referred to as the Section 7520 rate and is published monthly by the Treasury. The value of the income interest is merely the difference between the value of the remainder and the total value of the property*

21. [LO 3] Explain why the fair market value of a life estate is more difficult to estimate than an income interest.

*The calculation of a value of a life estate is a bit more complicated that an income interest because the time delay for the future payment of the remainder is unknown. To estimate this delay, the calculation is based upon the number of years the life tenant is expected to live. To facilitate the calculation, the regulations provide a table where the discount rate is calculated by including the life tenant’s age and life expectancy.*

22. [LO 3] Describe a reason why transfers of terminable interests should not qualify for the marital deduction.

*If terminable interests qualified for the marital deduction, then property would pass from the first spouse (upon death or gift) to the second spouse without transfer tax (because of the marital deduction). The interest would then terminate and the property would pass from the second spouse to the eventual owners without transfer tax because upon termination the second spouse had no property to transfer. Hence, if terminable interests qualified for the marital deduction, no transfer tax would be imposed on the transfer of this property.*

23. [LO 3] True or False: Including taxable gifts when calculating the estate tax subjects these transfers to double taxation. Explain.

*False. The objective of adding previously taxed transfers to the taxable estate is to allow the estate tax base to reflect all transfers, both intervivos and testamentary. Under a progressive tax rate schedule such an adjustment is designed to increase the marginal tax rate on the estate. Adjusted taxable gifts are not, however, subject to tax in the estate formula. To prevent double taxation of prior taxable gifts, the tentative estate tax is reduced by a credit for the taxes that would have been payable on the adjusted taxable gifts under the current tax rate schedule.*

24. [LO 3] People sometimes confuse the unified credit with the exemption equivalent. Describe how these terms differ and how they are related.

*The unified credit is the tax calculated on an amount of transfers that Congress intended to pass without imposition of either transfer tax (gift or estate). The amount of cumulative taxable transfers that can be made without exceeding the unified credit is called the applicable exemption amount (previously the exemption equivalent).*

25. [LO 4] Describe a reason why a generation-skipping tax was necessary to augment the estate and gift taxes.

*Donors discovered that transfers across multiple generations avoided the imposition of any gift or estate taxes until the termination of the remainder interest. For example, a gift of a terminable interest to a child with the remainder to a grandchild spans two generations. When this child’s interest terminates, no gift or estate tax is imposed even though the child had the full use of the property perhaps throughout his (or her) lifetime. The strategy here could be expanded to multiple generations with remainder interest transferred far into the future. Indeed, some states now allow perpetual trusts that in the absence of a generation-skipping tax would allow grantors to avoid all transfer taxes save the initial transfer to the trust.*

26. [LO 4] Explain why an effective wealth transfer plan necessitates cooperation between lawyers, accountants, and investment advisors.

*An integrated team is essential to a successful wealth transfer plan because transfer and income taxes only represent one piece of the puzzle. Lawyers are critical to constructing property rights to achieve tax and nontax objectives while investment advisors provide the economic input necessary for long-term plans. Obviously accountants provide much of the necessary tax expertise.*

27. [LO 4] Describe how to initiate the construction of a comprehensive and effective wealth plan.

*Wealth planning typically begins with understanding the individuals’ goals and objectives. These objectives include immediate goals, such as assuring a steady source of income, and longer-term goals, such as providing for a specific division of assets or providing educational support for dependents. Most wealth plans will likely have significant tax and nontax consequences. When considering tax factors, however, an effective wealth transfer plan should also anticipate the economic and legal ramifications that will accompany any transfer of wealth.*

28. [LO 4] List two questions you might pose to a client to find out whether a program of serial gifts would be an advantageous wealth transfer plan.

*The most obvious question would be whether the client could afford to make gifts given the level of income expected to be necessary to support the client in the future. Another important question involves the health/age of the client and the past and expected rate of appreciation for the proposed gift property. Serial giving is less beneficial for clients who might be expected to die soon and for property that has substantially appreciated in the past.*

29. [LO 4] A client in good health wants to support the college education of her teenage grandchild. The client holds various properties but proposes to make a gift of cash in the amount of the annual exclusion. Explain to the client why a direct gift of cash may not be advisable and what property might serve as a reasonable substitute.

*Transfers to support the education of a teenager should probably be made in trust because the donee will be able to spend any amounts given directly. Rather than cash, the gift could consist of property that is expected to appreciate rapidly in value thereby allowing the appreciation to escape the transfer tax.*

30. [LO 4] An elderly client has a life insurance policy worth $40,000 that upon her death pays $250,000 to her sole grandchild (or his estate). The client retains ownership of the policy. Outline for her the costs and benefits of transferring ownership of the policy to a life insurance trust.

*The benefit of the transfer is that the value of the policy ($250,000) would not be subject to the estate tax upon the client’s death if the client lives for at least three years after the transfer. The cost is that the transfer of the policy would constitute a taxable gift (to the extent that the value exceeds the annual exclusion) and might be subject to the generation skipping tax. In addition, in order to complete the transfer the client would need to give up (among other rights) the right to change the beneficiary of the policy.*

31. [LO 4] {Research} Identify the sections in the Internal Revenue Code that authorize the use of qualified terminable interests (QTIPs) for gift and estate tax purposes, respectively.

*The QTIP exceptions for the gift and estate taxes are provided in §2523(f ) and §2056(b)(7), respectively*

32. [LO 4] {Research} Under what conditions can an executor or trustee elect to claim a marital deduction for a transfer of a terminable interest to a spouse?

*The QTIP option provides an exception to the general prohibition against claiming a marital deduction for a transfer of a terminable interest. The conditions are that the (surviving) spouse is entitled to all of the income from the property payable at least annually and no person has the power to appoint any part of the property to anyone other than the (surviving) spouse until the death of the surviving spouse. For an intervivos transfer, the spouse must include the value of the property in her taxable gifts and for a testamentary transfer the executor must include the value of the property in the estate of the surviving spouse.*

33. [LO 4] Explain how a transfer of property as a gift may have income tax implications to the donee.

*Although a gift is not taxable income to the donee, there is no step-up in the tax basis of the transferred property. Hence, if the donee sells the property, any appreciation (including appreciation up to the date of the gift) will be taxed to the donee.*

**Problems**

34. [LO 2] Raquel transferred $100,000 of stock to a trust, with income to be paid to her nephew for 18 years and the remainder to her nephew’s children (or their estates). Raquel named a bank as independent trustee but retained the power to determine how much income, if any, will be paid in any particular year. Is this transfer a complete gift? Explain.

*Raquel has retained sufficient control that the transfer of the income interest to her nephew is incomplete – the gift to the nephew will be completed as income is actually distributed to him. However, the portion of the transfer representing the remainder interest is a complete gift because Raquel can no longer control this portion of the property.*

35. [LO 2] This year Gerry’s friend, Dewey, was disabled. Gerry paid $15,000 to Dewey’s doctor for medical expenses and paid $12,500 to State University for college tuition for Dewey’s son. Has Gerry made taxable gifts, and if so, in what amounts?

*Both payments were complete gifts, but both are exempt from the gift tax as long as the payments were made directly to the college or doctor.*

36. [LO 2] This year Dan and Mike purchased realty for $180,000 and took title as equal tenants in common. However, Mike was able to provide only $40,000 of the purchase price and Dan paid the remaining $140,000. Has Dan made a complete gift to Mike, and if so, in what amount?

*Dan has made a complete gift to Mike of $50,000 ($90,000[$180,000 × 50%] – $40,000) and the gift is eligible for an annual exclusion of $14,000.*

37. [LO 2] Last year Nate opened a savings account with a deposit of $15,000. The account was in the name of Nate and Derrick, joint tenancy with the right of survivorship. Derrick did not contribute to the account, but this year he withdrew $5,000. Has Nate made a complete gift, and if so, what is the amount of the taxable gift and when was the gift made?

*No gift was made at the time of the deposit, but a complete gift of $5,000 was made once Derrick made the withdrawal.*

38. [LO 2] Barry transfers $1,000,000 to an irrevocable trust with income to Robin for her life and the remainder to Maurice (or his estate). Calculate the value of the life estate and remainder if Robin’s age and the prevailing interest rate result in a Table S discount factor for the remainder of 0.27.

*The remainder is valued at $270,000 ($1 million × .27). Accordingly, the value of the life estate is $730,000 ($1,000,000 less $270,000).*

39. [LO 2] This year Jim created an irrevocable trust to provide for Ted, his 32-year-old nephew, and Ted’s family. Jim transferred $70,000 to the trust and named a bank as the trustee. The trust was directed to pay income to Ted until he reaches age 35, and at that time the trust is to be terminated and the corpus is to be distributed to Ted’s two children (or their estates). Determine the amount, if any, of the current gift and the taxable gift. If necessary, you may assume the relevant interest rate is 6 percent and Jim is unmarried.

*The $70,000 transfer to the trust is a current gift but only the income interest qualifies for an annual exclusion. The remainder interest is valued as follows:  
  
Remainder interest = $70,000 / (1 + .06) 3 = $70,000 / (1.191) = $58,774*

*The income interest is $70,000 – $58,774 =$11,226. Because the annual exclusion exceeds the income interest, the income interest of $11,226 is completely offset by the annual exclusion. The total taxable gift is the amount of the remainder, $58,774.*

40. [LO 2] This year Colleen transferred $100,000 to an irrevocable trust that pays equal shares of income annually to three cousins (or their estates) for the next eight years. At that time, the trust is terminated and the corpus of the trust reverts to Colleen. Determine the amount, if any, of the current gifts and the taxable gifts. If necessary, you may assume the relevant interest rate is 6 percent and Colleen is unmarried. What is your answer if Colleen is married and she elects to gift-split with her spouse?

*The $100,000 transfer to the trust is a current gift only to the extent of the income interest (the corpus returns to Colleen). In other words, Colleen has not transferred the reversion interest because it will return to her. The reversion interest is valued as follows:*

*Reversion interest = $100,000 / (1+.06)8 = $100,000 / (1.594) = $62,735 (rounded) The income interest is $100,000 – $62,735 = $37,265 (rounded).*

*Because the income interest is paid currently and to three donees, the gift will qualify for three $14,000 annual exclusions. In other words, Colleen made three gifts of $12,422 each. Hence, Colleen did not make any taxable gifts with this transfer because the annual exclusions completely offset each gift. If Colleen is married and elects to gift split, then the gifts would be evenly split between the spouses.*

41. [LO 2] Sly is a widower and wants to make annual gifts of cash to each of his four children and six grandchildren. How much can Sly transfer to his children this year if he makes the maximum gifts eligible for the annual exclusion? What is the amount of the total transfer if Sly is married and elects to gift splitting, assuming his spouse makes no other gifts?

*Sly can exclude $14,000 for each donee (four plus six is ten donees). Hence, he can exclude $140,000 of gifts this year. If Sly is married and makes gifts from community property or elects to gift split with his spouse, then $280,000 of gifts would be excluded this year (assuming the spouse didn’t make any gifts to these donees).*

42. [LO 2] Jack and Liz live in a community property state and their vacation home is community property. This year they transferred the vacation home to an irrevocable trust that provides their son, Tom, a life estate in the home and the remainder to their daughter, Laura. Under the terms of the trust, Tom has the right to use the vacation home for the duration of his life, and Laura will automatically own the property after Tom’s death. At the time of the gift the home was valued at $500,000, Tom was 35 years old, and the §7520 rate was 5.4 percent. What is the amount, if any, of the taxable gifts? Would your answer be different if the home was not community property and Jack and Liz elected to gift-split?

*There is a gift of a life estate to Tom and a remainder to Laura. Laura’s remainder interest is worth $67,040 ($500,000 × 0.13408) so the value of Tom’s life estate is $432,960 ($500,000 – $67,040). Since the gift is from community property, half of the gift was made by each spouse. In other words, Jack and Liz each made a gift of $33,520 ($67,040 × 50%) to Laura and $216,480 ($432,960 × 50%) to Tom. After applying the annual exclusion to the life estate (the remainder is a future interest and does not qualify for an annual exclusion), Jack and Liz each made taxable gifts of $33,520 and $202,480 ($216,480–$14,000).   
  
In a state that has common law instead of community property the answer would depend on whether the vacation home is held in joint ownership or the title is in the name of one spouse. If the title was held by one spouse, then the gift would be $67,040 to Laura and $418,960 (after the annual exclusion) to Tom. However, the couple could elect to gift split and the solution to the problem would be the same as in community property.*

43. [LO 2] David placed $80,000 in trust with income to Steve for his life and the remainder to Lil (or her estate). At the time of the gift, given the prevailing interest rate, Steve’s life estate was valued at $65,000 and the remainder at $15,000. What is the amount, if any, of David’s taxable gifts?

*The life estate is a present interest, but Lil’s remainder is a future interest. Hence, only the value of Steve’s life estate can be reduced by the annual exclusion. Hence, David has made two taxable gifts: a taxable gift of $51,000 to Steve ($65,000 less the annual exclusion of $14,000) and a taxable gift of $15,000 to Lil (no annual exclusion is available).*

44. [LO 2] Stephen transferred $15,000 to an irrevocable trust for Graham. The trustee has the discretion to distribute income or corpus for Graham’s benefit but is required to distribute all assets to Graham (or his estate) not later than Graham’s 21st birthday. What is the amount, if any, of the taxable gift?

*Stephen will be entitled to an annual exclusion for the transfer because the trust fits the description of a trust for the benefit of a minor. Hence, the taxable gift will be $1,000 ($15,000–$14,000 annual exclusion).*

45. [LO 2] For the holidays, Marty gave a watch worth $25,000 to Emily and jewelry worth $40,000 to Natalie. Has Marty made any taxable gifts this year and, if so, in what amounts? Does it matter if Marty is married to Wendy and they live in a community property state?

*After reducing each transfer for the annual exclusion, Marty has made a taxable gift of $11,000 to Emily and $26,000 to Natalie. However, if the gifts are from community property (or if Marty and his spouse elect to split gifts), then both Marty and his spouse made a gift of $12,500 to Emily and $20,000 to Natalie. After applying the annual exclusion, neither Marty nor his spouse made a taxable gift to Emily but each of them made a taxable gift of $6,000 to Natalie.*

46. [LO 2] This year Jeff earned $850,000 and used it to purchase land in joint tenancy with a right of survivorship with Mary. Has Jeff made a taxable gift to Mary and, if so, in what amount? What is your answer if Jeff and Mary are married?

*In a common law state, Jeff has made a gift to Mary of $425,000. However, if the couple is married, the entire transfer will be offset by an annual exclusion and a marital deduction, so there is no taxable gift.*

47. [LO 2] Laura transfers $500,000 into trust with the income to be paid annually to her spouse, William, for life (a life estate) and the remainder to Jenny. Calculate the amount of the taxable gifts from the transfers.

*The life estate is not eligible for the marital deduction because this interest will terminate upon a future event (William’s death) and then pass to another person (Jenny). Hence, the entire amount of the gift, less an annual exclusion for William’s life estate, will be a taxable gift ($500,000 – $14,000 = $486,000).*

48. [LO 2] Red transferred $5,000,000 of cash to State University for a new sports complex. Calculate the amount of the taxable gift.

*The gift qualifies for an annual exclusion and the remainder qualifies for the charitable gift tax deduction. Hence, there is no taxable gift. If Red makes no other gifts this year, he need not even file a gift tax return. Red can also claim an income tax deduction for the transfer.*

49. [LO 2] In 2010 Casey made a taxable gift of $5 million to both Stephanie and Linda (a total of $10 million in taxable gifts). Calculate the amount of gift tax due this year and Casey’s unused exemption equivalent under the following *alternatives*.

a. This year Casey made a taxable gift of $1 million to Stephanie. Casey is not married, and the 2010 gift was the only other taxable gift he has ever made.

b. This year Casey made a taxable gift of $5 million to Stephanie. Casey is not married, and the 2010 gift was the only other taxable gift he has ever made.

c. This year Casey made a gift worth $5 million to Stephanie. Casey is married to Helen in a common law state, and the 2010 gift was the only other taxable gift he or Helen has ever made. Casey and Helen elect to gift split.

*a. Assuming Casey was unmarried in 2010, Casey would have used $1 million of his applicable exemption amount with the 2010 gift (and paid tax on the gift above $10 million). In 2016, Casey would have an unused exemption equivalent of $4.45 million.*

*Current taxable gifts $ 1,000,000  
Prior taxable gifts +10,000,000  
 Cumulative taxable gifts $ 11,000,000*

*Casey would be allowed a credit for the tax on the 2010 gift calculated using the 2016 tax rate schedule ($3,945,800). Casey would use a portion of his remaining exemption equivalent to offset the remaining tax ($400,000) as follows.*

*Tax on cumulative taxable gifts $ 4,345,800  
 Less: Current tax on prior taxable gifts – 3,945,800  
Tax on current taxable gifts $ 400,000  
Unified credit on current taxable gifts – 400,000  
 Gift tax due $ 0*

*Note that Casey is in the top marginal gift tax rate and that $1 million times 40% equals the gift tax on current gifts of $400,000. Note also that at the end of 2016, Casey would have $3.45 million of unused exemption equivalent ($5.45 million – $1 million – $1 million).*

*b. In 2010, Casey used $1 million of his exemption equivalent, so in 2016 Casey would have an unused exemption equivalent of $4.45 million. This means that $550,000 of the current gift will not be covered by the exemption equivalent ($5,000,000 – $4,450,000 = $550,000).*

*Current taxable gifts $ 5,000,000  
Prior taxable gifts +10,000,000  
 Cumulative taxable gifts $ 15,000,000*

*The unused unified credit is the difference in the tax on the entire exemption equivalent less the tax on the used exemption equivalent calculated as follows:   
  
Current tax on full exemption equivalent ($5.45 million) $ 2,125,800  
 Less: tax on used exemption equivalent ($1 million) – 345,800  
Tax on current taxable gifts $ 1,780,000*

*Tax on cumulative taxable gifts $ 5,945,800  
 Less: Current tax on prior taxable gifts ($10 million) – 3,945,800  
Tax on current taxable gifts $ 2,000,000  
Unused unified credit on current taxable gifts – 1,780,000  
 Gift tax due $ 220,000*

*Note that Casey is in the top marginal gift tax rate and that $550,000 times 40% equals the gift tax on current gifts of $220,000. At the end of 2016, Casey would not have any unused exemption equivalent.*

*c. Under gift splitting, neither Casey nor Helen would owe any tax on the 2016 gifts. Casey and Helen will each be treated as having made a gift of $2.5 million and both gifts would be eligible for an annual exclusion. Hence, Casey and Helen each made a gift of $2,486,000 ($2.5 million – $14,000). In 2010, Casey used $1 million of his exemption equivalent, so in 2016 Casey would have an unused exemption equivalent of $4.45 million (a unified credit of $1,780,000 as calculated above). Casey will calculate the gift tax on his share of the gift as follows:*

*Current taxable gifts $ 2,486,000  
Prior taxable gifts +10,000,000  
 Cumulative taxable gifts $ 12,486,000*

*Tax on cumulative taxable gifts $ 4,940,200  
 Less: Current tax on prior taxable gifts ($10 million) – 3,945,800  
Tax on current taxable gifts $ 994,400  
Unified credit on current taxable gifts ($2.486 million) – 994,400  
 Gift tax due $ 0*

*Note that Casey is in the top marginal gift tax rate and that the gift of $2,486,000 times 40% equals the gift tax on current gifts of $994,400. At the end of 2016, Casey would still have an unused exemption equivalent of $1.964 million (5.45 million less $1 million used in 2010 less 2.486 million used in 2016).*

*Helen will owe no transfer taxes on her gift. Her gift will not result in any tax because in 2016 she has a $5.45 exemption equivalent available. After application of the 2016 exemption equivalent, Helen will have $2,964,000 of exemption equivalent remaining ($5.45 million – $2.486 million).*

50. [LO 3] {Tax Forms} Tom Hruise was an entertainment executive who had a fatal accident on a film set. Tom’s will directed his executor to distribute his cash and stock to his wife, Kaffie, the real estate to his church, The First Church of Methodology, and the remainder of his assets were to be placed in trust for his three children. Tom’s estate consisted of the following:

Assets:  
 Personal assets $ 800,000  
 Cash and stock 24,000,000  
 Intangible assets (film rights) 71,500,000  
 Real estate 15,000,000  
 $ 111,300,000  
Liabilities:  
 Mortgage $ 3,200,000  
 Other liabilities 4,100,000  
 $ 7,300,000

a. Tom made a taxable gift of $8 million in 2011. Compute the estate tax for Tom’s estate.

*Note that the applicable exemption amount in 2011 was $5 million, so Tom would have be able to use $1,200,000 of tax on adjusted taxable gifts from the 2011 gift. Tom’s estate will owe estate tax of $25,820,000 calculated as follows:*

|  |  |
| --- | --- |
| *Gross Estate* | *$ 111,300,000* |
| *Marital Deduction* | *– 24,000,000* |
| *Charitable Deduction* | *– 15,000,000* |
| *Debts* | *– 7,300,000* |
| *Taxable Estate* | *$ 65,000,000* |
| *Adjusted taxable gifts* | *+ 8,000,000* |
| *Cumulative taxable transfers* | *$ 73,000,000* |
|  |  |
| *Tax on cumulative transfers* | *$ 29,145,800* |
| *Current tax on adjusted taxable gifts* | *– 1,200,000* |
| *Tentative estate tax* | *$ 27,945,800* |
| *Unified Credit* | *2,125,800* |
| *Estate Tax Due* | *$ 25,820,000* |

*Tom’s estate is taxed at the highest estate tax rate. Hence, the estate tax is 40 percent of the cumulative transfers in excess of the exemption equivalent and the previously taxed gift. ($73 million – $5.45 million – 3 million = $64.55 million) $64.55 million × 40% – $25.82 million.*

1. Fill out lines 1 through 12 in part 2 of Form 706 for Tom’s estate.



51. [LO 3] Hal and Wendy are married, and they own a parcel of realty, Blackacre, as joint tenants with the right of survivorship. Hal owns an additional parcel of realty, Redacre, in his name alone. Suppose Hal should die when Blackacre is worth $800,000 and Redacre is worth $750,000, what value of realty would be included in Hal’s probate estate, and what value would be included in Hal’s gross estate?

*Redacre ($750,000) would be included in Hal’s probate estate because the title of this parcel would need to be changed through probate. In contrast, the title to Blackacre would not be included in Hal’s probate estate because the title would be changed automatically to Wendy’s name. Hal’s gross estate would include the value of the property subject to probate ($750,000) and half the value of the property held by husband and wife with the right of survivorship ($400,000).*

52. [LO 3] Walter owns a whole-life insurance policy worth $52,000 that directs the insurance company to pay the beneficiary $250,000 on Walter’s death. Walter pays the annual premiums and has the power to designate the beneficiary of the policy (it is currently his son, James). What value of the policy, if any, will be included in Walter’s estate upon his death?

*The face value of $250,000 will be included in Walter’s estate upon his death despite the fact that the proceeds will not need to go through probate and, instead, will be paid directly to the beneficiary.*

53. [LO 3] Many years ago James and Sergio purchased property for $450,000. Although they are listed as equal co-owners, Sergio was able to provide only $200,000 of the purchase price. James treated the additional $25,000 of his contribution to the purchase price as a gift to Sergio. Suppose the property is worth $900,000 at Sergio’s death, what amount would be included in Sergio’s estate if the title to the property was tenants in common? What if the title were joint tenancy with right of survivorship?

*If the title to the property is held as tenants in common Sergio would include half the value of the property ($450,000) in his estate. In contrast, if the title is held as joint tenancy with right of survivorship, Sergio would include the proportion of the value as the amount of the purchase price he initially provided. Sergio provided 4/9ths of the price ($200/$450) so his estate would include $400,000 ($900,000 × 4/9ths).*

54. [LO 3] Terry transferred $500,000 of real estate into an irrevocable trust for her son, Lee. The trustee was directed to retain income until Lee’s 21st birthday and then pay him the corpus of the trust. Terry retained the power to require the trustee to pay income to Lee at any time, and the right to the assets if Lee predeceased her. What amount of the trust, if any, will be included in Terry’s estate?

*The value of the trust assets would be included in Terry’s estate because she retains control over the income (the ability to force the trustee to distribute income) and has a contingent right of reversion.*

55. [LO 3] Last year Robert transferred a life insurance policy worth $45,000 to an irrevocable trust with directions to distribute the corpus of the trust to his grandson, Danny, upon his graduation from college, or to Danny’s estate upon his death. Robert paid $15,000 of gift tax on the transfer of the policy. Early this year, Robert died and the insurance company paid $400,000 to the trust. What amount, if any, is included in Robert’s gross estate?

*Robert died within three years of the date of gifting the life insurance, so the face value of the policy ($400,000) and the gift tax ($15,000) is included in his gross estate.*

56. [LO 3] {Research} Willie purchased a whole-life insurance policy on his brother, Benny. Under the policy, the insurance company will pay the named beneficiary $100,000 upon the death of the insured, Benny. Willie names Tess the beneficiary, and upon Benny’s death, Tess receives the proceeds of the policy, $100,000. Identify and discuss the transfer tax implications of this arrangement.

*Under Section 2511, neither the purchase of the insurance policy nor the designation of Tess as a beneficiary constitutes a taxable gift from Willie to Tess. Benny has never had any incidents of ownership, so under Section 2042 none of the proceeds is included in Benny’s estate at his death. However, under Goodman v. Comm., (2nd Cir, 1946), 156 F.2d 218, the payment of the proceeds to Tess constitutes a taxable gift from Willie to Tess of $86,000 (after application of the $14,000 annual exclusion).*

57. [LO 3] Jimmy owns two parcels of real estate, Tara and Sundance. Tara is worth $240,000 and Sundance is worth $360,000. Jimmy plans to bequeath Tara directly to his wife Lois and leave her a life estate in Sundance. What amount of value will be included in Jimmy’s gross estate and taxable estate should he die now?

*Both parcels will be included in Jimmy’s gross estate, but his executor will be able to claim a marital deduction for the value of Tara, $240,000. However, Jimmy will leave Lois a terminable interest in Sundance and this will not qualify for the marital deduction. Hence, Jimmy’s taxable estate will include the value of Sundance, $360,000.*

58. [LO 3] Roland had a taxable estate of $5.5 million when he died this year. Calculate the amount of estate tax due (if any) under the following alternatives.

a. Roland’s prior taxable gifts consist of a taxable gift of $1 million in 2005.

b. Roland’s prior taxable gifts consist of a taxable gift of $1.5 million in 2005.

c. Explain how the tax calculation would change if Roland made a $1 million taxable gift in the year prior to his death.

*a. The exemption equivalent for gifts in 2005 was $1 million so Roland has no tax for adjusted taxable gifts associated with the 2005 transfer. Roland’s executor would calculate the estate tax as follows:*

*Adjusted taxable gifts $ 1,000,000  
Taxable estate + 5,500,000  
Cumulative taxable transfers $ 6,500,000  
  
Tax on cumulative taxable transfers $ 2,545,800  
 Gift tax payable on adjusted taxable gifts – 0  
 Tax on taxable estate $ 2,545,800  
 Unified credit – 2,125,800  
Estimated estate tax due $ 420,000*

*Note that the top estate tax rate is 40 percent of the cumulative transfers in excess of the exemption equivalent ($6.5 million – $5.45 million = $1.05 million and $1.05 million × 40% = $420,000).*

*b. Note that because the exemption equivalent in 2005 was only $1 million, Roland’s estate would have tax payable on adjusted taxable gifts for the 2005 transfer. Roland’s executor would calculate the credit for prior taxable gifts at the current rate and calculate the unified credit using the 2005 exemption equivalent at the current tax rate. The credit for prior taxable gifts ($200,000) would be calculated as follows:*

*Current tax on prior taxable transfers ($1.5 million) $ 545,800  
Unified credit under current rate   
 ($1 million 2005 exemption equivalent) – 345,800  
 Credit for prior taxable gifts $ 200,000*

*The estate tax would be calculated as follows:   
  
Adjusted taxable gifts $ 1,500,000  
Taxable estate + 5,500,000  
Cumulative taxable transfers $ 7,000,000  
  
Tax on cumulative transfers $ 2,745,800  
 Credit for prior gifts at current rate – 200,000  
Tentative tax $ 2,545,800  
 Unified credit – 2,125,800  
Estimated estate tax due $ 420,000*

*Note that this solution is equivalent to the prior problem. Here the estate tax payable is 40 percent of the cumulative transfers in excess of the exemption equivalent and the previously taxed gift ($7 million – $5.45 million – $500,000 = $1.05 million).*

*c. If Roland died within 3 years of the $1 million gift, the estate would be increased by the amount of any gift tax actually paid on the gift because the gift was made within three years of the decedent’s death. However, if the gift did not exceed Roland’s unused exemption equivalent, then no gift tax would be paid for the gift.*

59. [LO 3] {Tax Forms} Brad and Angelina are a wealthy couple who have three children, Fred, Bridget, and Lisa. Two of the three children, Fred and Bridget, are from Brad’s previous marriages. On Christmas this year Brad gave each of the three children a cash gift of $10,000 and Angelina gave Lisa an additional cash gift of $40,000. Brad also gave stock worth $40,000 (adjusted basis of $10,000) to the Actor’s Guild (an “A” charity).

a. Brad and Angelina have chosen to split gifts. Calculate Brad’s gift tax. Assume that Angelina has no previous taxable gifts, but Brad reported previous taxable gifts of $2 million in 2009 when he used $345,800 of unified credit and paid $435,000 of gift taxes.

*a. Before gift splitting Brad has made personal gifts totaling $70,000 ($10,000 to three children and $40,000 to charity). With gift splitting Brad’s personal gifts are reduced to $35,000 but he must include half of Angelina’s gift and this increases his gifts to $55,000. Brad is allowed to claim annual exclusions for the gifts to his three children (limited to the amount of the gift for Fred and Bridget) and an additional annual exclusion for the charitable gift. The remainder of the charitable gift qualifies for a charitable deduction.*

|  |  |  |
| --- | --- | --- |
| ***Donees*** | ***Brad*** | ***Angelina*** |
| *Fred* | *$ 5,000* | *$ 5,000* |
| *Bridget* | *$ 5,000* | *$ 5,000* |
| *Lisa from Brad* | *$ 5,000* | *$ 5,000* |
| *Lisa from Angelina* | *$ 20,000* | *$ 20,000* |
| *Actor’s Guild* | *$ 20,000* | *$ 20,000* |
| *Total Gifts* | *$ 55,000* | *$ 55,000* |
| *Annual Exclusions ($5+$5+$14+$14)* | *– 38,000* | *– 38,000* |
| *Charitable Deduction* | *– 6,000* | *– 6,000* |
| *Total Taxable Gifts* | *$ 11,000* | *$ 11,000* |

*Brad would then calculate his gift tax as follows:*

|  |  |  |
| --- | --- | --- |
| *Previous taxable gifts (2009)* |  | *$ 2,000,000* |
| *Current taxable gift* |  | *11,000* |
| *Cumulative taxable transfers* |  | *$ 2,011,000* |
|  |  |  |
| *Current tax on cumulative transfers* |  | *$ 750,200* |
| *Current tax on prior taxable gifts* |  | *– 745.800* |
| *Current tax on current taxable gifts* |  | *$ 4,400* |
| *Unified credit used this year* |  | *– 4,400* |
| *Gift tax due* |  | *0* |

*Note that Brad’s gift is taxed at the highest gift tax rate ($11,000 × 40% = $4,400), and he will have an unused exemption equivalent of $3,439,000 available for future use ($5.45 million less $2 million less $11 thousand).*

b. Fill out parts 1 and 4 of Form 709 for Brad.

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **A** Item number | **B**  • Donee’s name and address  • Relationship to donor (if any)  • Description of gift  • If the gift was of securities, give CUSIP no.  • If closely held entity, give EIN | **C** | **D**  Donor’s adjusted basis of gift | **E** Date of gift | **F**  Value at date of gift | **G**  For split gifts, enter  1/2 of column F | **H**  Net transfer (subtract col. G from col. F) |
| 1 | **FRED – child** |  | **10,000** | **12/25** | **10,000** | **5,000** | **5,000** |
|  | **BRIDGET – child** |  | **10,000** | **12/25** | **10,000** | **5,000** | **5,000** |
|  | **LISA – child** |  | **10,000** | **12/25** | **10,000** | **5,000** | **5,000** |
|  | **ACTOR'S GUILD** |  | **10,000** | **12/25** | **40,000** | **20,000** | **20,000** |

Gifts made by spouse *—complete* ***only*** *if you are splitting gifts with your spouse and he/she also made gifts.*

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **LISA – child** |  | **40,000** | **12/25** | **40,000** | **20,000** | **20,000** |
|  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
| **Total of Part 1.** Add amounts from Part 1, column H . . . . . . . . . . . . . . . . . . . . . . a | | | | | | | **55,000** |

Form 709 Page **3**

**Part 4—Taxable Gift Reconciliation**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **1** Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3 . . . . . . . . . .  **2** Total annual exclusions for gifts listed on line 1 (see instructions) . . . . . . . . . . . . .  **3** Total included amount of gifts. Subtract line 2 from line 1 . . . . . . . . . . . . . . .  **Deductions** (see instructions)  **4** Gifts of interests to spouse for which a marital deduction will be claimed, based | | | | **1** | **55,000** |  |
| **2** | **38,000** |  |
| **3** | **17,000** |  |
|  | **6,000** |  |
| on item numbers of Schedule A . .  **5** Exclusions attributable to gifts on line 4 . . . . . . . . . . . .  **6** Marital deduction. Subtract line 5 from line 4 . . . . . . . . . . .  **7** Charitable deduction, based on item nos. **4** less exclusions . | **4** |  |  |
| **5** |  |  |
| **6** |  |  |
| **7** | **6,000** |  |
| **8** Total deductions. Add lines 6 and 7 . . . . . . . . . . . . . . . . . . . . .  **9** Subtract line 8 from line 3 . . . . . . . . . . . . . . . . . . . . . . . .  **10** Generation-skipping transfer taxes payable with this Form 709 (from Schedule C, Part 3, col. H, Total) . .  **11 Taxable gifts.** Add lines 9 and 10. Enter here and on page 1, Part 2—Tax Computation, line 1 . . . . | | | | **8** |
| **9** | **11,000** |  |
| **10** | 0 | 00 |
| **11** | **11,000** |  |

60. [LO 4] {Planning} Jones is seriously ill and has $6 million of property that he wants to leave to his four children. He is considering making a current gift of the property (rather than leaving the property to pass through his will). Assuming any taxable transfer will be subject to the highest transfer tax rate, determine how much gift tax Jones will owe if he makes the transfers now. How much estate tax will Jones save if he dies after three years, during which time the property appreciates to $6.8 million? Besides transfer taxes, what other tax and financial factors should Jones consider in making this choice?

*There are two critical assumptions here. First because the top transfer tax rate applies to all transfers (currently and for future transfers), it would appear that Jones has already used his exemption equivalent. Second, Jones survives at least three years (otherwise, the gift tax on any current transfer would be included in his estate). Under these assumptions a current gift of $6 million will result in a taxable gift of $5,944,000 (after four annual exclusions) and a gift tax of $2,377,600. In contrast, the same property transferred via the estate will trigger $2,720,000 in estate taxes. The difference in the amount transferred ($342,400) represents the $22,400 savings from the annual exclusions ($56,000 × 40%) and the $320,000 of estate tax on the $800,000 of appreciation. Below is the calculation of the tax savings and the net amount transferred to the children under both scenarios.*

|  |  |  |
| --- | --- | --- |
|  | ***Current Gift*** | ***Transfer at death*** |
| *Current value of property* | *$ 6,000,000* | *$ 6,000,000* |
| *Less gift tax on transfer (40%)* | *- 2,377,600* |  |
| *Value transferred via gift* | *$ 3,622,400* |  |
| *Appreciation during interim* | *+ 800,000* | *+ 800,000* |
| *Value transferred via estate* |  | *$ 6,800,000* |
| *Estate tax at 40%* |  | *– 2,720,000* |
| *After tax value transferred* | *$ 4,422,400* | *$ 4,080,000* |
|  |  |  |
| *Tax savings and extra value transferred* | *$ 342,400* |  |

*Jones should also consider the time value of money and income taxes in his decision. If he chooses to gift the property immediately, the gift tax will be payable now. If he waits to transfer the property at death, the transfer tax will be paid later. Jones should also consider the income tax consequences to the children. If Jones transfers the property via gift and his children intend to sell the property, then all accumulated appreciation will be included in the taxable income of the children. On the other hand, if the property is transferred via inheritance, then the appreciation will escape the income tax.*

61. [LO 4] Angelina gave a parcel of realty to Julie valued at $210,000 (Angelina purchased the property five years ago for $88,000). Compute the amount of the taxable gift on the transfer, if any. Suppose several years later Julie sold the property for $215,000. What is the amount of her gain or loss, if any, on the sale?

[Type a quote from the document or the summary of an interesting point. You can position the text box anywhere in the document. Use the Drawing Tools tab to change the formatting of the pull quote text box.]

*The gift is $196,000 after the annual exclusion. There would likely be no gift tax due unless Angelina has used her entire unified credit. Julie takes a carryover basis in the property (plus the gift tax paid, if any, on the appreciation). Julie realizes a gain of $127,000 upon the eventual sale ($215,000 – $88,000).*

62. [LO 4] {Research} Several years ago Doug invested $21,000 in stock. This year he gave his daughter Tina the stock on a day it was valued at $20,000. She promptly sold it for $19,500. Determine the amount of the taxable gift, if any, and calculate the amount of taxable income or gain, if any, for Tina. Assume Doug is not married and does not support Tina, who is 28.

*Doug made a current gift of $20,000 and a taxable gift of $6,000 (after the annual exclusion). Tina will not recognize any income upon receipt of the stock, and she takes a carryover basis of $21,000 and long-term holding period for income tax purposes. For purposes of calculating a loss, Tina’s basis in the stock is limited to the lesser of carryover basis ($21,000) or fair market value on the date of the gift ($20,000). Hence, upon the sale Tina recognizes a loss of $500.*

63. [LO 4] Roberta is considering making annual gifts of $14,000 of stock each to each of her four children. She expects to live another five years and to leave a taxable estate worth approximately $8,000,000. She requests you justify the gifts by estimating her estate tax savings from making the gifts.

*If the estimate of Roberta’s taxable estate is accurate and if the estate tax rates and annual exclusions do not change, Roberta would be able to use her annual exclusion of $14,000 to gift away $56,000 ($14,000 × 4) of property each year without incurring any tax. Hence, she would transfer a total of $280,000 ($56,000 × 5 years) that would save $112,000 in transfer taxes (at 40%). In addition, each transfer would eliminate the appreciation on the property between the time of the gift and Roberta’s death. For example, if the property appreciates at a 5 percent compound rate of return, the first gift of $56,000 would eliminate an additional $15,472 of appreciation {$56,000 × [(1.05)5–1]} from being subject to estate tax.*

64. [LO 4] Harold and Maude are married and live in a common law state. Neither has made any taxable gifts and Maude owns (holds title) all their property. She dies with a taxable estate of $15 million and leaves it all to Harold. He dies several years later, leaving the entire $15 million to their three children. Calculate how much estate tax is due on Harold’s estate.

*The estate tax on Harold’s estate would be calculated as follows:  
  
Cumulative taxable transfers $ 15,000,000  
  
Tax on cumulative transfers $ 5,945,800  
 Credit for prior gifts at current rate – 0  
Tentative tax $ 5,945,800  
 Applicable credit with DSUE – 4,305,800  
Estate tax due $ 1,640,000*

*Note that this solution is equivalent to taxing cumulative transfers in excess of the double exemption equivalent ($10.9 million) at the top tax rate (40%). Hence, $15 million – $10.9 million = $4.1 million and $4.1 million × 40% = $1.64 million.*

**Comprehensive Problems**

65. {Planning} Suppose Vince dies this year with a gross estate of $15 million and no adjusted prior gifts. Calculate the amount of estate tax due (if any) under the following *alternative* conditions.

a. Vince leaves his entire estate to his spouse, Millie.

b. Vince leaves $10 million to Millie and the remainder to charity.

c. Vince leaves $10 million to Millie and the remainder to his son, Paul.

d. Vince leaves $10 million to Millie and the remainder to a trust whose trustee is required to pay income to Millie for her life and the remainder to Paul.

*a. If all the property in Vince’s estate qualifies for the marital deduction, then there would be no taxable estate and there would be no estate tax due upon Vince’s death. If Millie dies with a taxable estate of $15 million, her estate would owe an estate tax of $3.82 million {($15 million – $5.45 million exemption equivalent) × 40%}. Of course, the value of the property would likely change over time and Millie’s consumption would decrease the property over the interim between the deaths of Vince and Millie.*

*b. Once again, if the property left to Millie qualifies for the marital deduction and if the property bequeathed to charity qualifies for the charitable deduction, then there would be no taxable estate and there would be no estate tax due upon Vince’s death.*

*c. Assuming that the property left to Millie qualifies for the marital deduction, the transfer to Paul would be less than the exemption equivalent, so no estate tax would be due.*

*d. The solution is identical to (c) above because the amount left in trust is a terminable interest that would not qualify for a marital deduction.*

66. Hank is a single individual who possesses a life insurance policy worth $300,000 that will pay his two children a total of $800,000 upon his death. This year Hank transferred the policy and all incidents of ownership to an irrevocable trust that pays income annually to his two children for 15 years and then distributes the corpus to the children in equal shares.

a. Calculate the amount of gift tax due (if any) on the gift. Assume that Hank has made only one prior taxable gift of $5 million in 2011.

b. Calculate the amount of cumulative taxable transfers for estate tax purposes if Hank dies this year but after the date of the gift. At the time of his death, Hank’s probate estate is $10 million divided in equal shares between his two children.

*a. Hank will owe no gift taxes calculated as follows:  
  
Gift of life insurance policy $ 300,000  
annual exclusions (two children) – 28,000  
Current taxable gifts $ 272,000  
 Prior taxable gifts + 5,000,000  
Cumulative gifts $ 5,272,000  
  
Tax on cumulative taxable transfers $ 2,054,600  
less Current tax on prior taxable gifts ($5 million) – 1,945,800  
Tax on current taxable gifts $ 108,800  
 Unified credit ($5.45 million) $ 2,125,800  
 less used unified credit ($5 million) – 1,945,800  
Unused unified credit – 180,000   
Gift tax due (Hank will have $71,200 of unified credit left) $ 0*

*b. Because Hank made the transfer of the life insurance within three years of his death, his estate will include the life insurance proceeds ($800,000) as well as any gift taxes paid on that transfer (none in this case). Hence, Hank’s cumulative taxable transfers will be calculated as follows:*

*Probate estate $ 10,000,000  
Life insurance proceeds + 800,000  
Gift taxes on transfer within 3 years of death + 0  
 Gross estate $ 10,800,000  
Prior taxable transfers + 5,000,000  
Cumulative taxable transfers $ 15,800,000*

*Note that Hank’s estate would not, however, include the $272,000 gift of the insurance in adjusted taxable gifts. To do otherwise would subject the transfer of the insurance policy to double tax – once under the gift tax and again under the estate tax.*

67. Jack is single and he made his first taxable gift of $1,000,000 in 2008. Jack made additional gifts in 2009, at which time he gave $1,750,000 to each of his three children and an additional $1,000,000 to State University (a charity). The annual exclusion in 2009 was $13,000. Recently Jack has been in poor health and would like you to estimate his estate tax should he die this year. Jack estimates his taxable estate (after deductions) will be worth $5.4 million at his death.

*The solution begins with the estimation of Jack’s cumulative taxable transfers. The transfer to State University is deducted when computing taxable transfers and the gifts to the children are eligible for an annual exclusion. Cumulative taxable transfers are calculated as follows:*

*Gross estate $ 5,400,000  
Prior taxable transfers in 2008 1,000,000  
Prior taxable transfers in 2009 (($1,750,000 – $13,000) × 3) + 5,211,000  
Cumulative taxable transfers $ 11,611,000*

*Next, it is necessary to calculate the amount of credit for prior taxable transfers. The 2008 transfer was offset by Jack’s unified credit ($1 million exemption equivalent) but none of the taxable transfer in 2009 was offset by the exemption equivalent because Jack used the exemption equivalent in 2008. Hence, Jack made a $5.211 million taxable transfer in 2009. The credit for prior taxable transfers is calculated using the current rate schedule as follows:*

*Tax on taxable transfers ($6.211 million) $ 2,430,200  
less unified credit ($1 million) – 345,800  
Current tax payable on prior taxable gifts $ 2,084,400*

*The calculation of the estate tax proceeds as follows:*

*Tax on cumulative taxable transfers of $11,611,000 $ 4,590,200  
less current tax payable on prior taxable gifts – 2,084,400  
 Tentative tax $ 2,505,800  
less Unified credit ($5.45 million) – 2,125,800  
 Estate tax due $ 380,000*

*Note that Jack’s estate would be in the top marginal tax rate but that only a portion of the gross estate of $5.4 million would be subject to transfer tax because Jack could use the remaining $4.45 million of exemption equivalent to offset the tax (he only used $1 million of exemption equivalent in 2008 and none in 2009). Hence, only $950,000 of the estate is subject to tax ($5.4 million – $4.45 million). At the highest tax rate, this generates $380,000 of tax ($950,000 times 40%).*

68. Montgomery has decided to engage in wealth planning and has listed the value of his assets below. The life insurance has a cash surrender value of $120,000 and the proceeds are payable to Montgomery’s estate. The trust is an irrevocable trust created by Montgomery’s brother 10 years ago and contains assets currently valued at $800,000. The income from the trust is payable to Montgomery’s faithful butler, Walen, for his life, and the remainder is payable to Montgomery or his estate. Walen is currently 37 years old and the §7520 interest rate is currently 5.4 percent. Montgomery is unmarried and plans to leave all his assets to his surviving relatives.

Property Value Adjusted Basis

Auto $ 20,000 $ 55,000  
Personal effects 75,000 110,000  
Checking and savings accounts 250,000 250,000  
Investments 2,500,000 770,000  
Residence 1,400,000 980,000  
Life insurance proceeds 1,000,000 50,000  
Real estate investments 5,125,000 2,800,000  
Trust 800,000 80,000

a. Calculate the amount of the estate tax due (if any), assuming Montgomery dies this year and has never made any taxable gifts.

b. Calculate the amount of the estate tax due (if any), assuming Montgomery dies this year and made one taxable gift in 2006. The taxable gift was $1 million, and Montgomery used his unified credit to avoid paying any gift tax.

c. Calculate the amount of the estate tax due (if any), assuming Montgomery dies this year and made one taxable gift in 2006. The taxable gift was $5 million, and Montgomery used his unified credit to avoid paying any gift tax. Montgomery plans to bequeath his investments to charity and leave his remaining assets to his surviving relatives.

*Each part of the solution depends on the value of Montgomery’s taxable estate. Montgomery’s estate includes the fair value (the adjusted basis of the assets is irrelevant) of all of his assets except the trust because Montgomery only owns a remainder interest in the trust at his death. Hence, only the value of the remainder is included in his estate. The remainder is valued by identifying the discount factor given the §7520 interest rate (5.4%) and the age of the life tenant (37 years). The value ($123,600) is obtained by multiplying the discount factor (0.1545 from Exhibit 25-4) times the value of the trust assets ($800,000). Hence, the value of Montgomery’s estate is calculated as follows:*

*Auto $20,000   
Personal effects 75,000  
Checking and savings accounts 250,000  
Investments 2,500,000  
Residence 1,400,000  
Life insurance proceeds 1,000,000  
Real estate investments 5,125,000  
Trust ($800,000 × .1545) 123,600  
 Value of estate at date of death $10,493,600*

*a. Montgomery’s estate tax is calculated as follows:  
  
Adjusted taxable gifts $ 0  
Taxable estate + 10,493,600  
Cumulative taxable transfers $ 10,493,600  
Tax on cumulative transfers $ 4,143,240  
Current tax payable on adjusted taxable gifts - 0  
 Tax on taxable estate $ 4,143,240  
 Unified credit – 2,125,800  
Estimated estate tax due $ 2,017,440*

*b. Montgomery’s estate tax is calculated as follows:  
  
Adjusted taxable gifts $ 1,000,000  
Taxable estate + 10,493,600  
Cumulative taxable transfers $ 11,493,600  
Tax on cumulative transfers $ 4,543,240  
Current tax payable on adjusted taxable gifts – 0  
 Tax on taxable estate $ 4,543,240  
 Unified credit – 2,125,800  
Estimated estate tax due $ 2,417,440*

*c. Montgomery’s estate tax is calculated as follows:  
  
Gross estate $ 10,493,600  
Charitable deduction – 2,500,000  
 Taxable estate $ 7,993,600  
Adjusted taxable gifts + 5,000,000  
Cumulative taxable transfers $ 12,993,600  
Tax on cumulative transfers $ 5,143,240  
Current tax payable on adjusted taxable gifts:  
 Adjusted taxable gifts $ 5,000,000  
 Less unified credit (2006) – 1,000,000  
 Taxable gift $ 4,000,000  
Current tax payable on adjusted taxable gifts – 1,545,800  
 Tax pay  
 Tax on taxable estate $ 3,597,440  
 Unified credit – 2,125,800  
Estimated estate tax due $ 1,471,640*

*Over his lifetime Montgomery made taxable transfers of $12,993,600 but he paid tax on $4 million of his 2006 transfer and used his exemption equivalent of $5.45 million to reduce lifetime transfers to $3,543,600. These transfers were taxed at 40% resulting in the tax of $1,417,440. The difference of $54,200 is because the reduction for taxes paid on adjusted taxable gifts was not made at the highest tax rate. If the reduction was for $1.6 million ($4 million at 40%), then the tax due would be equal to $1,417,440!*