

## Chapter 16

### ESTATE AND GIFT TAXATION

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#### INTRODUCTION

This exercise offers a brief introduction to federal estate and gift taxation. Trusts and estates classes often cover the subject, albeit briefly, because many estate planning decisions are based on tax consequences. In addition, even when cases from a textbook have nothing to do with tax, the estate plans they reflect often contain elements that were the result of tax planning. Understanding the tax context will help you understand the whole case.

The federal estate and gift taxes apply to gratuitous transfers of wealth. States may also impose estate taxes, gift taxes, or inheritance taxes, but our focus here will be solely on the federal estate and gift taxes. The two taxes are unified — they apply to the same kinds of transfers, at the same rates, and with the same lifetime exemption. The exemption, which is really called the “Applicable Exclusion Amount,” is the amount that an individual can give away over a lifetime or at death without incurring any transfer tax liability. The Applicable Exclusion Amount is indexed for inflation, and in 2014 it is \$5,340,000, so tax is only imposed on the value of assets transferred above \$5,340,000. For example, if a decedent leaves an estate of \$6,000,000 in 2014, the estate tax is only imposed on \$660,000 [\$6,000,000 minus \$5,340,000].

Because the federal estate and gift taxes are unified, an individual can use the Applicable Exclusion Amount when making gifts during life. Gifts may also qualify for the *annual exclusion*, which is indexed for inflation. As of 2014, the first \$14,000 of gifts to any one individual in one year simply does not count at all. There are some conditions on this special tax treatment, but the annual exclusion is available per *donee* per year, and there is no limit on the number of annual exclusion gifts a taxpayer can make in a year. For example,

if a donor gave \$10,000 cash to each of her 10 grandchildren, none of those gifts would be taxable, and they would not count against the Applicable Exclusion Amount. She could make these gifts each year, and none of them would be taxable. On the other hand, if she gave each grandchild \$20,000 in one year, \$6,000 per grandchild would be “taxable” and she would use up \$60,000 of her Applicable Exclusion Amount, or if she had already used up her Applicable Exclusion Amount, she would have to pay gift tax. So the *timing* of annual gifts can be important.

## **MARITAL ISSUES**

For married couples, there are two additional planning tools. First, there is a deduction for transfers to a spouse. Accordingly, most gifts between spouses do not create gift tax liabilities, and most testamentary transfers to a spouse are not subject to the estate tax. There are some exceptions, however, which means that with careful planning, a married couple can choose which assets will be included in each estate. Without planning, on the other hand, all of the couple’s assets typically will end up in the survivor’s estate, which under prior federal law could mean that the survivor’s estate exceeded the Applicable Exclusion Amount. Many cases, including some you may read in your textbook, involve using a trust that does NOT qualify for the marital deduction so that some of the assets are included in the first spouse’s taxable estate.<sup>1</sup>

Under current law, we have another tool, however: the portability of the Applicable Exclusion Amount. When a married person dies, the spouse can “inherit” any unused Applicable Exclusion Amount. For example assume A and B are married, and each owns \$5,000,000 in assets. A dies and leaves everything to B. Because of the unlimited marital deduction, A’s taxable estate is 0 and no estate tax is due. B, the survivor, now owns \$10,000,000. Under prior law, when B dies, B’s estate would be subject to estate tax because it exceeds \$5,340,000. But under current law, B gets to use A’s unused

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<sup>1</sup> Important note: in the states that impose an estate tax, this is still an issue. State laws may not have changed along with the federal estate tax.

Applicable Exclusion Amount as well as B's own Applicable Exclusion Amount, so B's estate will also escape the estate tax. Thus, as of 2014, a married couple who has not used their Applicable Exclusion Amounts for lifetime gifts can pass \$10,680,000 free of estate tax at the survivor's death.

**SKILLS INVOLVED:** Using forms, fact development and analysis, tax planning, and writing

**GENERAL DESCRIPTION OF EXERCISE:** Determine estate tax liability and develop strategies for minimizing estate tax liability for a surviving spouse; prepare a federal estate tax return.

**PARTICIPANTS NEEDED:** This is an individual exercise to be completed by one student.

**ESTIMATED TIME REQUIRED**

**Task 1:** 15-30 minutes

**Task 2:** 30-60 minutes

**Task 3:** 30-60 minutes

**Task 4:** 1 hour, if you complete tasks 1 & 2 first; 2 hours otherwise

**LEVEL OF DIFFICULTY (1-5): 3**

**ROLE IN EXERCISE:** You are acting as lawyer for the Estate of Dora Mora and will be completing the federal estate tax return for her estate. In addition, you will be advising Dora's surviving spouse, Herbert.

**APPLICABLE LAW:** Assume there is no state estate or inheritance tax in Dora Mora's state of residence. The current law regarding federal estate and gift tax as of the year you are completing the exercise will be the applicable law.

## **THE EXERCISE**

Dora Mora died on January 6 of this year, survived by her husband, Herbert, and their two daughters, Sophie Mora and Giovanna Mora. Dora was a U.S. citizen, and has lived in Springfield, State, for her entire life. At the time of Dora's death, she was living with her husband, Herbert Mora, in a house that she and Herbert owned as joint tenants.

Dora was born on November 7, 1942, in Springfield, and Herbert was born on August 23, 1940, also in Springfield, State. Dora's probate proceedings are pending in Columbia County Superior Court under case number 10-4-3367.

Dora died testate. Her will appointed Sophie Mora as executor. The will leaves \$200,000 to the Columbia County Audubon Society. It leaves \$500,000 to each of her daughters, and it leaves all of the residue to Herbert. All of Dora's gifts during her lifetime were small — less than the annual exclusion amount — so she did not make any taxable gifts.

You have already prepared the Inventory and the Pleadings for opening the Estate. Dora's probate assets as reported on the Inventory were the following:

1. A stock portfolio:
  - a. 212,500 shares of Microsoft common stock
  - b. 200 shares of Berkshire Hathaway Class A common
  - c. 5,000 shares of common stock of Walmart
2. A 5-year-old Prius worth \$14,000
3. Household furnishings worth approximately \$15,000.
4. A separate savings account in Dora's name alone, account number 007, with a balance of \$4,222.

In addition, Dora and Herbert had a joint bank account, and they owned their home in joint tenancy:

1. The home legally described as Lot 1, University Addition, Columbia County, State, valued at \$835,000.

2. A bank account at Bedford Savings Bank, in the name of Dora and Herbert as joint tenants, account number 0276 with a balance of \$19,442.

Finally, Herbert owned a \$500,000 life insurance policy on Dora. He is the beneficiary. He also owns a \$500,000 life insurance policy on himself. The current cash value of that policy is \$200,000.

The estate had to pay a number of expenses. Dora and Herbert owed a few bills at the time of Dora's death, but they were all joint, so Herbert will take care of them. Dora's funeral cost \$5,000. You have determined that your fees as attorney for handling the estate will be \$7,000 plus \$380 in costs. There were appraiser's fees of \$2,000. The accountant's fees will be \$6,300.

Here are the names, addresses, and social security numbers for Dora, Herbert, and their two daughters:

Dora Mora  
000-34-0120  
244 Boat Street  
Springfield, State

Hebert Mora  
000-44-2222  
244 Boat Street  
Springfield, State

Sophie Mora  
000-34-1111  
1400 Lakeview Drive  
Springfield, State  
Phone: 000-123-4567

Giovanna Mora  
000-34-2222  
875 NW 12<sup>th</sup> Avenue  
Springfield, State

## RESOURCES

- Andersen, *Understanding Trusts and Estates*, Chapter 14
- The LexisNexis Web Course that was created for this book includes links to the IRS website, to IRS Form 706, and to the Instructions for Form 706. Read the Instructions carefully — they will help you.

## **TASK I:**

Determine the value of the Gross Estate. Your first task will be to determine the value of the stock and determine the values of the probate assets in the estate. In general, you would have done this in preparing the Inventory. In addition, you will need the values of any assets held in joint tenancy, as well as the value of any life insurance proceeds.

Look up the approximate values of the stocks on the date of death. The symbols for the companies are as follows:

- Berkshire Hathaway BRK-A
- Microsoft MSFT
- Walmart WMT

You can find these on the Internet. Some links are provided on the LexisNexis Web Course, or you can use your own favorite. Use the closing price on the date of death for each of the stocks. If the date of death falls on a weekend or holiday, or the market was closed on the date of death for any other reason, use the closing price on the last day the market was open before the date of death.

**NOTE: This is not the valuation method required under the instructions to Form 706.** We are using a simplified method for this exercise because obtaining the information in the form required by the IRS can be complicated, and practitioners usually use a valuation service for the information put onto the return. The purpose of having you look up the values with the simplified method is to introduce you to valuation resources and give

you the skills necessary for the preliminary work on a tax return, which would include an estimated value of assets.

**TASK 2:**

Determine the Taxable Estate. Examine Form 706 and identify the *Schedules* you will need in order to report all of the assets and expenses on the federal estate return. It may help to begin with *Part 5—Recapitulation* on page 3 of the main return. Determine the Gross Estate, Deductions, and Taxable Estate (lines 1 through 3a of the main return). Is the Taxable Estate more than 5,340,000? Will the estate be required to pay estate tax? Write a short memo to the file providing this information.

**TASK 3:**

Write a memo to the file describing any tax planning steps you think Herbert needs to take at this point. Will his estate be subject to estate tax when he dies? How can he minimize the burden by making lifetime gifts or transferring life insurance to a trust?

**TASK 4:**

Prepare the Form 706 and required schedules. You can find Form 706 on the IRS website: [www.irs.gov](http://www.irs.gov). All of the schedules will be included in the same PDF file. If you search for 706, you will also find the Instructions for Form 706.

The forms on the IRS website can be filled in online. To save the data you enter, click on PRINT and then change your printer to “Save as PDF” or “print to PDF”. (If you try to merely save the document using the Save function, you will lose the data you entered.)