Chapter 2

Federal Estate and Gift Taxation of U.S. Citizens Living Outside the United States and Resident Aliens*

§ 2:1 Introduction
§ 2:2 Citizenship
§ 2:2.1 Loss of Citizenship
§ 2:3 Residence
§ 2:3.1 Effect of Residence and Nonresidence for Federal Income Tax Purposes
[A] Definition of a Resident Alien Individual Since the Deficit Reduction Act of 1984
[B] Residency Starting Date and Residency Termination Date
§ 2:3.2 Effect of Residence and Nonresidence for Federal Estate and Gift Tax Purposes
§ 2:4 Estate Taxation of Resident Aliens
§ 2:4.1 Computation of Tax
§ 2:4.2 Gross Estate and Value
§ 2:4.3 Section 2035
§ 2:4.4 Section 2036
§ 2:4.5 Section 2037
[A] Value of Reversionary Interest
[B] Overlap Between Sections 2036 and 2037
§ 2:4.6 Section 2038

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§ 2:4.7 Overlap Between Sections 2038 and 2036
§ 2:4.8 Section 2041
[A] Date of Creation
[B] Exceptions to Includibility in Estate
[C] Release and Disclaimer
[D] Lapse of Power
§ 2:4.9 Section 2043
§ 2:4.10 Other Code Provisions
[A] Section 2039
[B] Section 2042
[C] Summary
§ 2:5 Deductions and Credits
§ 2:5.1 Deductions
§ 2:5.2 Credits
[A] Applicable Exclusion Amount
[B] Gift Tax Credit
[C] Credit for Tax on Prior Transfers
[D] Credit for Foreign Death Taxes
§ 2:6 Gift Taxation of U.S. Citizens and Resident Aliens
§ 2:6.1 Joint Tenancies with Right of Survivorship
§ 2:6.2 Computation of Gift Tax
§ 2:6.3 Annual Exclusion
§ 2:6.4 Charitable Deductions
§ 2:6.5 Marital Deduction
§ 2:7 Generation-Skipping Transfer Tax
§ 2:8 Conclusion

§ 2:1 Introduction

In the United States, there are three primary federal taxes that apply to international estate planning. All deal with the taxation of the transfer of assets and are sometimes referred to as "transfer taxes." These are the federal estate tax, the federal gift tax, and the federal generation-skipping transfer tax.[1] A fourth tax, the federal income tax (including the capital gains tax), is beyond the purview of this chapter, although it will be discussed from time to time.

It should be noted that the applicable provisions of the Code, and the regulations pertaining to these transfer taxes, may be affected by

1. Each of the federal estate tax, the federal gift tax, and the federal generation-skipping transfer tax has been affected significantly by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 [hereinafter "Tax Act of 2001" or "the Act"], the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 [hereinafter the "Tax Act of 2010"] and the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313.

one or more of the treaties (conventions) to which the United States is a party. Therefore, if a treaty jurisdiction is involved, it is imperative that the treaty be reviewed.

The United States has entered into estate tax treaties with Australia,[2] Austria, Belgium,[3] Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Switzerland, and the United Kingdom[4] and gift tax treaties with Australia, Austria, Denmark, France, Germany, Japan, and the United Kingdom. The estate and gift tax treaties with Austria, Denmark, France, Germany, and the United Kingdom have provisions pertaining to generation-skipping transfer taxes, as does the Model Estate and Gift Tax Treaty.[5]

In addition to federal taxes, many states impose an estate tax or an inheritance tax. These cannot be overlooked. The impact of the state tax deduction against the federal estate tax must be carefully considered.[6]

The generation-skipping transfer tax applies to certain lifetime and testamentary transfers of property to or for the benefit of persons at least two generations younger than that of the transferor.[7] The tax applies to distributions of income as well as corpus. Depending on which of three possible taxable events triggers the tax, the tax is to be paid either by the transferor, the transferee, or the trustee of the trust.[8]

The regime of federal estate and gift taxation for individuals is based on citizenship, on residence, or, in the case of persons who are neither citizens of nor resident aliens in the United States (nonresident aliens), on where the assets are situated. Therefore, if a person is a U.S. citizen (either by birth or naturalization), or a resident in the United States, he will be subject to federal estate taxation on his worldwide assets and gift taxation on gifts made by him anywhere in

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2. The Australian federal estate duty was abolished with respect to the estate of any person dying after July 1, 1979.
3. Belgium and the United States signed an estate tax treaty in 1954. It was approved by the U.S. Senate in 1955 but it never entered into force.
4. The estate tax treaty with Canada terminated for estates of decedents dying on or after January 1, 1985. A revised Protocol, effective November 9, 1995, adds rules concerning taxation at death to the convention between the United States and Canada with respect to taxes on income and on capital.
5. *See* chapter 3.
6. *See* I.R.C. § 2058.
7. The generation-skipping transfer tax was originally introduced by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976), and then modified as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). *See supra* note 1.
8. *See* section 2:7, *infra*.

the world. On the other hand, if a person is neither a citizen of the United States nor a resident in the United States, he will be subject to federal estate taxes only on assets owned by him and situated in the United States at the time of his death, and to federal gift taxes only on real property and tangible property (not intangible property) that is situated in the United States at the time of his gift.

The classification of a person as a U.S. citizen or resident alien, on the one hand, or as a nonresident alien, on the other hand, will also affect the deductions, the credit for the applicable exclusion amount, and, perhaps, the tax basis in the hands of the successor taker. Thus, the first issue to be addressed is the classification of an individual as a U.S. citizen, a resident alien, or a nonresident alien.

§ 2:2 Citizenship

The determination of a person's citizenship is an objective factual matter; while it should be easily determinable, it is often misunderstood. A common misconception is that a person can be the citizen of only one country at any given time. In several circumstances, a person who is a citizen of another country also may be a citizen of the United States without realizing it.

For example, if a person is born in the United States of nonresident alien parents, he is a citizen of the United States.[9] If a person is born in Puerto Rico, the Virgin Islands, or Guam after specified dates, he is a citizen of the United States.[10] If a person is born in the Republic of Panama or the Canal Zone after specified dates, and that person's mother and/or father was a U.S. citizen at the time of the person's birth, he is a U.S. citizen.[11] If a person is born in an outlying possession of the United States[12] with one U.S. citizen parent who was physically present in the United States (including American Samoa and Swains Island) for a continuous period of one year prior to the birth, he is a U.S. citizen.[13] If a person is born outside the

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9. 8 U.S.C. § 1401(a). However, persons born in the United States to nonresident alien parents with recognized diplomatic status and full diplomatic immunity are not U.S. citizens by reason of birth because they were not subject to the jurisdiction of the United States at the time of their birth. *See* 8 STATE DEP'T, FOREIGN AFFAIRS MANUAL 212.1; INS INTERPRETATIONS 301.1(a)(4); *see also* 1 C. GORDON & S. MAILMAN, IMMIGRATION LAW AND PROCEDURE § 1.03[8][c] (1992) [hereinafter GORDON & MAILMAN].
10. 8 U.S.C. §§ 1402, 1406–07.
11. 8 U.S.C. § 1403.
12. 8 U.S.C. § 1101(a)(29) defines the term "outlying possessions of the United States" to mean American Samoa and Swains Island.
13. 8 U.S.C. § 1401(e).

United States (including American Samoa and Swains Island), he is a U.S. citizen if any of the following conditions exist:

(1) both parents were U.S. citizens and at least one of the parents was previously a resident in the United States (including American Samoa and Swains Island);[14]

(2) one parent was a U.S. citizen and was present in the United States (including American Samoa and Swains Island) for a continuous period of one year prior to the birth, and the other parent is a national (as opposed to a citizen)[15] of the United States;[16]

(3) one parent was an alien and the other parent was a U.S. citizen who was present in the United States (including American Samoa and Swains Island) for a period or periods aggregating not less than five years, at least two years of which occurred after that parent attained the age of fourteen years;[17] or

(4) the birth occurred between January 12, 1941, and December 24, 1952, and one parent was a U.S. citizen who served in the armed forces between December 31, 1946, and December 24, 1952.[18]

The right of a person born outside the United States to claim citizenship through a citizen parent is based entirely on statute. Therefore, the statute in effect at the time of the person's birth should be consulted.[19] The periods of residence required of a U.S. citizen parent in order to confer U.S. citizenship on his or her child have been changed several times over the years.[20] Also, prior to 1978, all persons who acquired U.S. citizenship by birth abroad after May 24, 1934, to a citizen parent, the other parent being an alien, were subject to a retention requirement. Such a person lost his nationality and citizenship if he were not continuously present in the United States for at

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14. 8 U.S.C. § 1401(c).
15. A "national" is a citizen of the United States or a person who owes permanent allegiance to the United States. The term "national" applies to persons born in outlying possessions of the United States, such as American Samoa and Swains lsland, who are not U.S. citizens. *See* 8 U.S.C. §§ 1101(a)(22), 1408.
16. 8 U.S.C. § 1401(d).
17. 8 U.S.C. § 1401(g); Immigration and Nationality Act Amendments of 1986, Pub. L. No. 99-653, § 12, 100 Stat. 3655, 3657 (1986).
18. 8 U.S.C. § 1401(g).
19. *See* GORDON & MAILMAN, *supra* note 9, at § 1.03[8][d].
20. *See id.*

least two years between the ages of fourteen and twenty-eight.[21] The repeal of this provision in 1978 was not retroactive.[22] Therefore, the citizenship status of any person born abroad between 1934 and 1978 to one citizen parent and one alien parent must be examined in light of this retention requirement.

Depending on the laws of other jurisdictions with which such person may have a connection or relationship, such as the laws of the jurisdiction where one or both of his parents is a citizen, he also may be a citizen of one of those jurisdictions.

§ 2:2.1 Loss of Citizenship

Furthermore, a person mistakenly may believe that he has lost his U.S. citizenship by the commission of certain acts. However, not only must the person commit one of the several acts set out by statute, but he must do so voluntarily and with the intent to surrender his U.S. nationality.[23]

Thus, a U.S. citizen, whether native-born or naturalized, will lose his citizenship if he voluntarily does any of the following with the requisite intent:

- becomes a citizen of a foreign jurisdiction after having attained the age of eighteen;
- takes an oath of allegiance to a foreign jurisdiction after having attained the age of eighteen;

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21. Section 1 of the Act of October 27, 1972, Pub. L. No. 92-584, 86 Stat. 1499 (codified at 8 U.S.C. § 1401(b)) (repealed 1978). The 1972 statute also provided that nationality and citizenship would be retained if the alien parent was naturalized while the child was under the age of eighteen and the child began to reside permanently in the United States while under the age of eighteen. *Id.*

22. Section 1 of the Act of October 10, 1978, Pub. L. No. 95-432, 92 Stat. 1046.

23. 8 U.S.C. § 1481(a). In 1986, the Immigration and Nationality Amendments to the U.S.C. codified the standard set forth in Vance v. Terrazas, 444 U.S. 252, 261 (1980) (in establishing loss of U.S. citizenship, the government must prove an intent to surrender it, not just the voluntary commission of an expatriating act such as swearing allegiance to a foreign nation), *reh'g denied*, 445 U.S. 920 (1980), *on remand*, Terrazas v. Muskie, 494 F. Supp. 1017 (N.D. Ill. 1980), *aff'd sub nom.* Terrazas v. Haig, 653 F.2d 285 (7th Cir. 1981). *See also* Breyer v. Meissner, 214 F.3d 416 (3d Cir. 2000); T. Aleinikoff, *Symposium on Law and Community: Theories of Loss of Citizenship*, 84 MICH. L. REV. 1471 (1986), which discusses the case of *In re* Kahane (Dep't of State, Bd. of App. Review, May 1, 1986) (unpublished opinion, on file at *Michigan Law Review*). There it was determined that the acceptance of a governmental position, a seat on the Israeli Parliament, was an act of expatriation, notwithstanding the fact that Rabbi Kahane did not intend to renounce his U.S. citizenship.

- enters or serves in the armed forces of a foreign state if (a) such armed forces are engaged in hostilities with the United States or (b) he serves as a commissioned or noncommissioned officer;
- assumes public office of a foreign jurisdiction's government after having attained the age of eighteen if he has acquired the nationality of that foreign jurisdiction or if an oath of allegiance is required for the office;
- formally renounces his U.S. citizenship before a foreign service officer abroad;
- formally renounces his U.S. citizenship during wartime, subject to approval by the attorney general of the United States; or
- is convicted of treason or the attempted forceful overthrow of the U.S. government.[24]

The requirement of an intention to expatriate as a prerequisite to the loss of U.S. citizenship can have a significant tax effect. Many persons who do not think of themselves as U.S. citizens may in fact be citizens and be subject to the federal estate tax on their worldwide assets or to the federal gift tax on gifts of property situated outside the United States.

A case in point involved a suit by the United States to recover back income taxes from a French-born, naturalized U.S. citizen who had established a residence in France in 1946 and remained a resident there until 1952.[25] At the time, U.S. law provided that a naturalized U.S. citizen would lose his nationality by residing continuously for three years in the foreign state of former nationality or birth. Thus, as of 1949, the defendant's U.S. citizenship was technically lost. Not until 1952, however, did she receive notice of the loss of her U.S. citizenship. Until that time, she had regarded herself as a U.S. citizen and had traveled on a U.S. passport.

In 1965, the U.S. State Department notified her that her expatriation was void because of a then recent Supreme Court decision and that the State Department considered her a U.S. citizen. The United States then sought back taxes for money earned in the 1949–58 period. The court, however, allowed back taxes only for the period 1949–52, when the defendant considered herself a U.S. citizen, and affirmatively exercised a specific right of citizenship by traveling on a U.S. passport.[26]

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24. 8 U.S.C. § 1481(a)(1)–(7).
25. United States v. Lucienne D'Hotelle de Benitez Rexach, 558 F.2d 37 (1st Cir. 1977).
26. 558 F.2d at 42–43.

The Internal Revenue Service (IRS) addressed this same problem in a 1975 ruling involving a natural-born U.S. citizen who became a citizen of the United Kingdom in 1910 by marrying a subject of the United Kingdom. As a result, she lost her U.S. citizenship under provisions of the immigration and nationality law subsequently declared unconstitutional.[27] The IRS concluded that the involuntarily expatriated citizen had all along been a U.S. citizen subject to taxation. As to the collection of back income taxes, the IRS ruled that its decision would not apply unless during the period of "expatriation" the individual had affirmatively exercised a specific right of citizenship.[28] The same principle should apply in the context of the federal estate and gift tax laws, although no authority exists.

There are a number of other problem situations involving the citizenship status of married females and citizens or residents in U.S. possessions.[29] Estate and gift tax provisions that apply to U.S. citizens who have expatriated are discussed separately.[30] The foregoing discussion emphasizes, however, that the status of a person's citizenship should be carefully analyzed.

§ 2:3 Residence

While a person's citizenship is generally easy to ascertain, a person's residence is often subjective and sometimes a problem to determine. The concept of residency itself is confusing because residence has different meanings for federal income and federal estate and gift tax purposes. The following sections discuss the separate tests for determining whether an individual is a resident of the United States for federal income tax purposes, on the one hand, and federal estate and gift tax purposes, on the other hand.

§ 2:3.1 Effect of Residence and Nonresidence for Federal Income Tax Purposes[31]

For federal income tax purposes, the test for determining whether an individual is a resident is not based on the concept of domicile. Although both residence and domicile require physical presence in a

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27. Rev. Rul. 75-357, 1975-2 C.B. 5.
28. *Id.* at 6.
29. *See* Heimos, *Non-Citizens Estate, Gift and Generation-Skipping Taxation*, 2d TAX MGMT. (BNA § III.B.5. (2011)).
30. *See* chapter 3.
31. This analysis does not consider the applicable provisions for the taxation of capital gains realized from the disposition of an interest in U.S. real property, either directly or indirectly, by the nonresident alien. *See* I.R.C. § 897.

jurisdiction for more than a transitory period, domicile requires an intention to make a place a fixed and permanent home, while residence only requires temporary physical presence or obtaining permanent resident status for U.S. immigration law purposes.[32] Thus, an individual may be domiciled in one jurisdiction yet reside in another,[33] and although theoretically he can have only one domicile,[34] he can at the same time have more than one residence.[35] Although it would have seemed logical for the United States to have always had precise rules to determine whether an alien is a resident or nonresident of the United States for federal income tax purposes, none existed until the Deficit Reduction Act of 1984 (DEFRA).[36]

In general, resident alien status applies only to individuals who are not U.S. citizens by either birth or naturalization under the U.S. Constitution and the Immigration and Nationality Act of 1952.

[A] Definition of a Resident Alien Individual Since the Deficit Reduction Act of 1984

Until DEFRA, the terms "resident alien" and "nonresident alien" were not defined by the Code. Although the relevant regulations attempted to correct this problem, the determination of status basically rested on judicial determinations of a subjective nature. Consequently, a new section was added to the Code.[37] Under Code section 7701(b), an alien individual will be considered

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32. Comm'r v. Nubar, 185 F.2d 584 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951).
33. Stallforth v. Comm'r, 30 B.T.A. 546 (1934), *aff'd*, 77 F.2d 548 (D.C. Cir.), *cert. denied*, 296 U.S. 606 (1935).
34. *But see In re* Dorrance's Estate, 309 Pa. 151, 163 A. 303 (1932), *cert. denied sub nom.* Dorrance v. Pennsylvania, 287 U.S. 660 (1932), *and* 288 U.S. 617 (1933); *In re* Dorrance's Estate, 115 N.J. Eq. 268, 170 A. 601 (Prerog. Ct.), *supplemental opinion*, 116 N.J. Eq. 204, 172 A. 503 (Prerog. Ct. 1934), *aff'd sub nom.* Dorrance v. Martin, 13 N.J. Misc. 168, 176 A. 902 (1935), *aff'd*, 116 N.J.L. 362, 184 A. 743, *cert. denied*, 298 U.S. 678 (1936).
35. Comm'r v. Swent, 155 F.2d 513 (4th Cir.), *cert. denied*, 329 U.S. 801 (1946), *citing In re* Newcomb's Estate, 192 N.Y. 238, 250, 84 N.E. 950, 954 (1908); Friedman v. Comm'r, 37 T.C. 539 (1961); *see also* Priv. Ltr. Rul. 78-42-002 (June 20, 1978) and cases cited therein.
36. Pub. L. No. 98-369, 98 Stat. 494.
37. I.R.C. § 7701(b), which defines both resident alien and nonresident alien.

a U.S. resident for any calendar year in which either one of two tests is met:

(1) The individual is a lawful permanent resident of the United States at any time during the calendar year; or

(2) The individual is "substantially present" in the United States.[38]

An alien individual would meet the first test if he had a valid visa to reside permanently in the United States, namely a "green card."[39] This status attaches whether he has ever lived in or visited the United States.[40] Thus, if an individual were to have this status as a precaution against future dislocation from the country where he is living, he would be deemed a U.S. resident for federal income tax purposes.[41]

The second test, the substantial presence test, is satisfied if an alien individual is physically present in the United States in a calendar year for a period of 183 days or more. A look-back rule also applies so that even if an alien individual is not physically present in the United States for 183 days or more in a calendar year, he may nevertheless be a resident of the United States if

(i) he is physically present in the United States for at least thirty-one days during that calendar year and

(ii) his presence in that year and the two preceding years equals a weighted aggregate of 183 days or more (pursuant to the application of a specific formula).[42]

The applicable statutory formula for calculating the 183-day period provides that each day of any calendar year will count as one day, each day of the first preceding calendar year will count as one-third of a day, and each day of the second preceding calendar year will count as

38. In addition, under certain circumstances, an alien individual may elect to be treated as a resident of the United States. I.R.C. § 7701(b)(1)(A)(iii), (b)(4).

39. Treas. Reg. § 301.7701(b)-1(b)(1).

40. Visas to reside permanently in the United States are for fixed terms and must be renewed periodically to remain valid.

41. This definition should not affect the determination of the status of a trust or estate.

42. I.R.C. § 7701(b)(3)(A).

one-sixth of a day.[43] Thus, an alien can spend up to 121 days each year in the United States without becoming a resident under the substantial presence test.

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43. For purposes of determining if the 183-day period has been fulfilled, the following chart, which was prepared by Harvey P. Dale, Esq., Director of the National Center of Philanthropy and the Law at New York University School of Law and former Counsel to Cadwalader, Wickersham & Taft LLP, New York, New York, sets forth the application of the substantial presence test pursuant to various factual patterns. Note that for purposes of the 183-day calculation, any resulting fractional days will not be rounded to the nearest whole number. Treas. Reg. § 301.7701(b)-1(c)(1).

DAYS PRESENT CURRENT YEAR	DAYS PRESENT PRIOR YEAR	DAYS PRESENT SECOND PRIOR YEAR	DAYS PRESENT (WEIGHTED SUM)	RESIDENT?
183	0	0	183	Yes
121	121	121	181	No
122	122	122	183	Yes
1	365	365	183	No
31	304	304	183	Yes
31	303	303	182	No
31	365	181	182	No
31	365	182	183	Yes
31	273	365	182	No
31	274	365	183	Yes
121	121	129	182	No
121	121	130	183	Yes
122	122	121	182	No
31	0	366	92	No
31	366	0	153	No
60	366	0	182	No
61	366	0	183	Yes
61	365	0	182	No
182	0	5	182	No
182	0	6	183	Yes
182	2	0	183	No
182	3	0	183	Yes

There are two exceptions to the substantial presence test. The first applies to an alien who is physically present in the United States for at least thirty-one days but fewer than 183 days during the current year (but more than 183 days pursuant to the application of the three-year formula) and who has a tax home in, and closer connection to, a foreign country.[44] The burden of proof would be on the alien to prove that he had a tax home in, and closer connection to, the foreign country.[45]

The so-called second exception applies to "exempt individuals." This exception provides that an alien will not be treated as present in the United States on any day that he is in the United States under exempt status. Exempt alien individuals are the following:

(1) Foreign government-related individuals—A foreign government-related individual is someone who is temporarily present in the United States by reason of:
   (a) diplomatic status or a visa that the secretary of the treasury (after consultation with the secretary of state) determines represents full-time diplomatic or consular status;[46]
   (b) a full-time employee of an international organization;[47] or
   (c) a member of the immediate family of such a diplomat or international organization employee.[48]

(2) Teacher or trainee—A teacher or trainee is any individual, other than a student, who is admitted temporarily to the United States under a J visa or a Q visa (subparagraph J or Q of section 101(15) of the Immigration and Nationality Act)

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44. I.R.C. § 7701(b)(3)(B). See also I.R.C. § 911(d)(3) for the definition of a "tax home" in a foreign country. However, for purposes of I.R.C. § 7701(b)(3)(B), the definition of "tax home" under I.R.C. § 911(d)(3) is to be applied without regard to whether a place of abode is available to him in the United States.

45. Treas. Reg. § 301.7701(b)-2(c)(1) provides that an individual's "tax home" is considered to be located at his regular or principal place of business, or if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode. An individual claiming the exception must file a detailed statement including significant disclosure of the individual's worldwide financial affairs and tax status. Further, relief under the closer connection exception is not automatic. On the contrary, the IRS may request additional information or deny an individual's claim for the application of such exception or both. Thus, the individual may make considerable disclosure of his tax and financial affairs and be denied the benefit of the exception.

46. I.R.C. § 7701(b)(5)(B)(i); Treas. Reg. § 301.7701(b)-3(b)(2)(i), (iii).

47. *Id.* § 7701(b)(5)(B)(ii); Treas. Reg. § 301.7701(b)-3(b)(2)(i).

48. *Id.* § 7701(b)(5)(B)(iii); Treas. Reg. § 301.7701(b)-3(b)(8).

and who substantially complies with the requirements of being so admitted.[49]

(3) Student—A student is any individual admitted temporarily to the United States under either an F visa or an M visa or as a student under a J visa or Q visa (subparagraphs F, M, J, or Q of section 101(15) of the Immigration and Nationality Act) and who substantially complies with the requirements of being so admitted.[50]

(4) A professional athlete who is temporarily in the United States to compete in a charitable sports event.[51]

Certain restrictions apply to the categories of teachers or trainees and students. The exemption will not apply to a teacher or trainee if for any two calendar years during the preceding consecutive six calendar years, such person was an exempt person as a teacher, trainee or student.[52] Furthermore, the exemption will not apply to a student in any calendar year after the fifth calendar year for which such student was exempt,[53] unless he establishes to the satisfaction of the Secretary of the Treasury that he did not intend to reside in the United States and that he substantially complies with the student visa requirements.

In addition, certain days of presence in the United States do not count for purposes of the substantial presence test. Ordinarily, presence in the United States is defined as any day that an individual is physically present in the United States for any part of the day. An exception exists for an alien individual who is in the United States for less than twenty-four hours while in transit between two points

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49. I.R.C. § 7701(b)(5)(A)(ii), (C); Treas. Reg. § 301.7701(b)-3(b)(3).

50. I.R.C. § 7701(b)(5)(A)(iii), (D). Treas. Reg. § 301.7701(b)-3(b)(4). The individual will be deemed to substantially comply with the visa requirements relevant to residence for U.S. federal income tax purposes if he is not engaged in activities that are prohibited by the Immigration and Nationality Act, and the regulations thereunder, and which could result in the loss of his F, J, or M visa status. Treas. Reg. § 301.7701(b)-3(b)(6). An F visa is for a student enrolled in a full-time academic course of study; a J visa is for an exchange visitor registered with certain approved exchange-visitor programs (designed to interchange knowledge and skills in the fields of education, arts and sciences); an M visa is for a vocational (nonacademic) student; and a Q visa is for an exchange visitor participating in an international cultural exchange program designated by the Immigration and Naturalization Service.

51. I.R.C. § 7701(b)(5)(A)(iv); Treas. Reg. § 301.7701(b)-3(b)(5); see also I.R.C. § 274(l)(1)(B) for description of a charitable sports event.

52. I.R.C. § 7701(b)(5)(E)(i). However, in the case of an individual all of whose compensation is described in I.R.C. § 872(b)(3), the maximum duration of the exception shall be four years rather than two years.

53. I.R.C. § 7701(b)(5)(E)(ii).

outside the United States. Provided that he conducts no business while in the United States,[54] he will not be treated as present in the United States on any day during such transit.[55] Another exception applies to an alien individual who regularly commutes to the United States from Canada or Mexico, in which case days during which he is present in the United States for purposes of his employment will not be counted as days present in the United States.[56] There is also an exception (like an exemption) for days spent in the United States by any alien individual who is unable to leave the United States because of a medical condition that arose while the individual was present in the United States.[57] This exception would not apply to an alien individual who came to the United States for medical treatment of an existing condition even if he were required to stay longer than anticipated due to complications.[58]

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54. Treas. Reg. § 301.7701(b)-3(d).
55. I.R.C. § 7701(b)(7)(C).
56. I.R.C. § 7701(b)(7)(B) provides:

> (B) *Commuters from Canada or Mexico*— If an individual regularly commutes to employment (or self-employment) in the United States from a place of residence in Canada or Mexico, such individual shall not be treated as present in the United States on any day during which he so commutes.

Treas. Reg. § 301.7701(b)-3(e)(2)(i) defines the term "commutes." Noting that an alien will not be considered to be present in the United States on days that the individual regularly commutes from Mexico or Canada, the regulation states that the term "commutes" means to travel to employment or self-employment and to return to one's residence within a twenty-four-hour period. Treas. Reg. § 301.7701(b)-3(e)(2)(i). According to the regulation, an alien individual will be considered to commute "regularly" if he commutes to his location of employment or self-employment in the United States from his residence in Mexico or Canada on more than 75% of the workdays during the working period (*i.e.*, that period during the current year beginning with the first day the individual is required to be physically present in the United States for employment or self-employment and ending with the last such day). Treas. Reg. § 301.7701(b)-3(e)(1), (2)(iii). Thus, if a Mexican or Canadian resident were to commute from Mexico or Canada on Monday and back to Mexico or Canada on Friday he would not fall under the commuter exemption, since travel to his employment and return to his residence would not occur within one twenty-four-hour period. This may cause some hardship to some individuals (for example, salespeople) who may have to travel in the United States over a period of days for business purposes but cannot really be said to reside here. However, this view of "commuting" is consistent with the Service's treatment of commuting in the context of business expenses under I.R.C. § 162. Accordingly, any extended business trips to the United States by an alien individual also would not fall under the commuter exception.

57. I.R.C. § 7701(b)(3)(D)(ii).
58. Treas. Reg. § 301.7701(b)-3(c)(3).

If an alien individual wishes to claim an exemption for the substantial presence test, he would have to file detailed information explaining the basis of his belief that an exemption or exception applies to his situation,[59] since the presumption is that if he meets the substantial presence test he is a resident alien for income tax purposes. An alien individual may not wish to disclose such information and, therefore, the reporting requirements may not be an acceptable alternative to the alien individual, in which case it would be necessary that he not place himself in such a position.

[B] Residency Starting Date and Residency Termination Date

Specific rules apply to determining the beginning and ending dates of an individual's resident alien status. With respect to the beginning date, if an individual were not a resident alien in the preceding year he would be treated as a resident alien only during the portion of the year that begins on the "residency starting date,"[60] which normally is the first day during the calendar year he is in the United States as a lawful permanent resident or the first day he is present in the United States if he meets the substantial presence test.[61]

If an individual is a resident of the United States by virtue of the substantial presence test, he will cease to be a resident when the test's physical presence requirements are no longer satisfied. In the case of a lawful permanent resident ("green card holder"), however, the rules are much more stringent because once an individual has been classified as a lawful permanent resident he remains one for so long as he holds his green card, irrespective of whether he continues to reside in the United States. In this respect, the Treasury Regulations provide that an individual's status as a lawful permanent resident is deemed to continue for U.S. federal income tax purposes unless the green card is rescinded or administratively or judicially determined to have been abandoned.[62] An administrative or judicial determination of abandonment may be initiated by the individual, the U.S. Immigration and Naturalization Service (INS), or by a consular officer. If the individual were to initiate this determination, his resident alien status would be considered abandoned when his application for abandonment

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59. *Id.* § 301.7701(b)-8.
60. I.R.C. § 7701(b)(2)(A).
61. If an individual satisfies both the lawful permanent resident and the substantial presence tests, the starting date will be the earlier of (i) the first day during the calendar year that he was present in the United States as a lawful permanent resident or (ii) the first day of the calendar year that he is physically present in the United States for purposes of the substantial presence test. Treas. Reg. § 301.7701(b)-4(a).
62. *Id.* § 301.7701(b)-1(b).

(INS Form I-407) or a letter stating his intent to abandon his resident status is sent to the INS or a consular officer, together with the Alien Registration Receipt Card (that is, the green card).[63]

The residency termination date for an individual who meets the lawful permanent resident test, then, is the first day during the calendar year on which the alien is no longer a lawful permanent resident if the alien establishes that, for the remainder of the calendar year, his tax home was in another country[64] and that he maintained a closer connection to that other country than to the United States,[65] and if he does not become a resident of the United States at any time

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63. An individual who abandons his U.S. residence during the taxable year and who is not a citizen or resident of the United States on the last day of such year must file IRS Form 1040NR for the taxable year and attach a separate schedule to show the income tax computation for the part of the taxable year during which the individual was a resident. Treas. Reg. § 1.6012-1(b)(2)(ii)(b).

64. A nonresident alien's tax home is considered to be located at his regular or principal place of business. Treas. Reg. § 301.7701(b)-2(c)(1).

65. The determination of whether an individual has maintained a closer connection to a country other than the United States depends upon the facts and circumstances regarding where he maintains significant contacts. In determining whether an individual has maintained more significant contacts with another country than with the United States, the facts and circumstances to be considered include, but are not limited to, the following:

    (i) the location of the individual's permanent home. It is immaterial whether a permanent home is a house, an apartment, or a furnished room. It also is immaterial whether the home is owned or rented by the alien individual. It is material, however, that the dwelling be available at all times, continuously, and not solely for stays of short duration;
    (ii) the location of the individual's family;
    (iii) the location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual or his family;
    (iv) the location of social, political, cultural or religious organizations with which the individual has a current relationship;
    (v) the location where the individual conducts his routine personal banking activities;
    (vi) the location where the individual conducts business activities (other than those that constitute the individual's tax home);
    (vii) the location of the jurisdiction in which the individual holds a driver's license;
    (viii) the location of the jurisdiction in which the individual votes;
    (ix) the country of residence designated by the individual on forms and documents; and
    (x) the types of official forms and documents filed by the individual, such as IRS Form 1078 (Certificate of Alien Claiming Residence in the United States), IRS Form W-8 (Certificate of Foreign Status) or IRS Form W-9 (Payee's Request for Taxpayer Identification Number).

    Treas. Reg. § 301.7701(b)-2(d).

during the next calendar year.[66] The residency termination date for an individual who satisfies the substantial presence test is the first day during the calendar year on which the alien is no longer physically present in the United States, if the alien establishes that for the remainder of the calendar year his tax home was in, and he maintained a closer connection to, another country and he does not become resident of the United States at any time during the next calendar year.[67]

Furthermore, de minimis physical presence of ten or fewer days in a year can be disregarded for purposes of determining either an individual's residency starting date or residency termination date under the substantial presence test, although such days will be counted for purposes of determining whether the individual meets the substantial presence test.[68] In order to benefit from this rule, the individual must file a statement with the IRS that details, among other items, the dates he was present in the United States (and that are sought to be disregarded) and that provides sufficient facts to establish that during such period, he maintained his tax home in, and a closer connection to, a foreign country.[69]

In order to prevent tax avoidance, there is also a special rule with regard to a resident alien individual of the United States, who subsequently ceases to be treated as a resident, and then resumes residence in the United States.[70] If this rule applies, a former resident may nevertheless become subject to U.S. federal income tax after his residency termination date on certain U.S. source income.[71] This rule applies only if

(i) the alien individual has been a resident for at least three consecutive years prior to his residency termination date;

(ii) the period of residence for each of the three consecutive calendar years includes at least 183 days;

(iii) the individual is taxed as a nonresident after his residency termination date; and

(iv) the individual becomes a resident of the United States again within three years of his residency termination date.[72]

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66. I.R.C. § 7701(b)(2)(B); Treas. Reg. § 301.7701(b)-4(b)(2).
67. I.R.C. § 7701(b)(2)(B); Treas. Reg. § 301.7701(b)-4(b)(2).
68. I.R.C. § 7701(b)(2)(C).
69. Treas. Reg. §§ 301.7701(b)-4(c)(1), 301.7701(b)-8(b)(3).
70. I.R.C. § 7701(b)(10); Treas. Reg. § 301.7701(b)-5.
71. I.R.C. §§ 877(b), 872(a), and 877(d). Under these Code sections, the source rules are expanded and there is gain recognition on certain exchanges that would otherwise be tax-free.
72. Treas. Reg. § 301.7701(b)-5.

The definitional rules discussed in this section for determining whether an individual is a U.S. resident for federal income tax purposes are not intended to override the treaty obligations of the United States. Thus, an individual who is classified as a U.S. resident under either the lawful permanent resident test or the substantial presence test may nevertheless qualify as an income tax resident of a foreign country if he is also a resident of a treaty country pursuant to that treaty country's internal laws, and is assigned residence to that country under the "tie breaker" provisions of an income tax treaty between that country and the United States. Generally, in such a case, the individual may claim residency in the foreign country (and not the United States) for all purposes of computing his U.S. federal income tax liability, not just for treaty purposes.[73] In order to claim residence in a treaty country for purposes of computing his U.S. federal income tax liability, the nonresident alien must file an IRS Form 1040NR on or before the due date prescribed by law (including extensions) for making an income tax return as a nonresident.[74]

§ 2:3.2 Effect of Residence and Nonresidence for Federal Estate and Gift Tax Purposes

U.S. citizens (no matter where they reside or are domiciled) and resident aliens are subject to federal estate taxes in the same manner and at the same rates. All of U.S. citizens' and resident aliens' property, wherever located at the time of their deaths, is includible in their gross estates.[75] A similar rule applies to federal gift taxes: generally, all gifts made by U.S. citizens and resident aliens are subject to tax no matter where the property is located or where the gift is completed, unless the gift avoids taxation for some other reason (for example, by qualifying for the annual exclusion).[76]

Nonresident aliens are subject to federal estate taxes at the same rates applicable to U.S. citizens and residents, but only on assets situated in the United States at the time of their deaths.[77] Such aliens

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73. *Id.* § 301.7701(b)-7.
74. An IRS Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) must be attached to the Form 1040NR and both should be sent to the Internal Revenue Service, Austin, TX 73301-0215 U.S.A. Treas. Reg. §§ 301.7701(b)-7(b), (c) and 301.6114-1.
75. I.R.C. §§ 2001, 2031–46.
76. *Id.* §§ 2501(a)(1), 2503(b).
77. *Id.* §§ 2103–05. The reduction, expiration, and resumption of the federal estate tax rates under the Tax Act of 2001 generally apply to nonresident aliens. *See supra* note 1. However, under the Act, the federal estate and gift tax exemption amount for nonresident aliens of $60,000 does not

are subject to federal gift taxes only with respect to transfers (by trust or otherwise) by them of real or tangible property (but generally not intangible property)[78] situated in the United States.[79] If the gift is of a "present interest" in property, the first $14,000 of such gifts to any person shall be excluded from the total amount of gifts made for that year.[80]

Thus, the consequences of the federal estate and gift tax provisions depend on the classification of the person to be taxed. As in the federal income tax provisions, there are three classifications of persons: U.S. citizens, resident aliens, and nonresident aliens.

The determination of U.S. citizenship is the same for all federal tax purposes, but, as noted earlier, residence for federal estate and gift taxes is equated to domicile.[81]

Interestingly, the tax laws (and specifically the treaty provisions) refer to domicile as if it were a federal law question. Historically, the question of domicile has been a matter for the application of state law rather than federal law, and only a few court decisions discuss domicile in a federal context.[82]

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increase; principal distributions from pre-2010 QDOTs will remain subject to federal estate tax until 2021 (*see* section 2:5.1, *infra*); and testamentary transfers of property to nonresident aliens will trigger federal income tax gain recognition as of January 1, 2010 (*see* section 3:5, *infra*).

78. I.R.C. § 2501(a)(2).

79. *Id.* § 2511.

80. The annual gift tax exclusion amount of $10,000 is adjusted for inflation for gifts made after 1998 (in 2014, the exclusion amount is $14,000). *Id.* § 2503(b); Rev. Proc. 2013-35, 2013-2 C.B. 537. In addition, the benefit of gift-splitting (whereby a gift made by either spouse is treated as having been made one-half by each, resulting in an annual exclusion of $20,000 ($28,000 in 2014 as adjusted for inflation per donee)) is available only if at the time of the gift each spouse is a citizen or resident of the United States. *Id.* § 2513.

As to the federal estate tax, *see* Treas. Reg. § 20.0-1(b)(1), (2), and as to the federal gift tax, *see* Treas. Reg. § 25.2501-1(a), (b). *See also* Farmers' Loan & Trust Co. v. United States, 60 F.2d 618 (S.D.N.Y. 1932); Bloch-Sulzberger v. Comm'r, 6 T.C.M. 1201 (1947); Fifth Ave. Bank v. Comm'r, 36 B.T.A. 534 (1937), *acq.*, 1937-2 C.B. 9, and cases cited therein.

81. The principle of domicile is discussed in chapter 1 and should be reviewed at this point.

82. Generally, state law governs most matters for which domicile is relevant and usually the question of one's domicile is raised with regard to a particular state. For example, when a question as to the existence of diversity jurisdiction arises under 18 U.S.C. § 1332, it is necessary to have state citizenship (the equivalent of state domicile). *See, e.g.*, Haggerty v. Pratt Inst., 372 F. Supp. 760 (E.D.N.Y. 1974); Pemberton v. Colonna, 189 F. Supp. 430 (E.D. Pa. 1960), *aff'd per curiam*, 290 F.2d 220 (3d Cir. 1961).

The Treasury Regulations for both federal estate and gift tax purposes provide that a person acquires a domicile in a place by living there, even for a brief period of time. Domicile, the Treasury Regulations state, is physical presence "with no definite present intention of later removing therefrom."[83] Residence "without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal."[84] The same factors considered for income tax purposes prior to DEFRA are still relevant for federal estate and gift tax purposes but the focus is more on the alien's subjective state of mind (his intention) as manifested by his actions. Because the standard of domicile is based on subjective criteria and the standard of residence is based on objective criteria, a person can be a resident alien for income tax purposes while a nonresident alien for estate or gift tax purposes.[85] The converse is also possible.

The immigration status of an alien is as important a factor for estate and gift tax purposes as for income tax purposes, and, under given circumstances, may not bar the intent necessary for a finding of domicile in the United States. The factor has been the subject of several revenue rulings and a U.S. Supreme Court case.

Initially, the IRS ruled that even though an alien was employed in the United States in circumstances that seemed to make him a resident for income tax purposes, he was not one for estate tax purposes because his nonimmigrant visa made him incapable of forming the requisite intention to be domiciled in the United States.[86] This ruling was revoked, however, by Revenue Ruling 80-363.[87]

Revenue Ruling 80-363 involved a decedent who was a citizen of a foreign country and who entered and remained in the United States on a nonimmigrant visa for approximately thirteen years. The IRS determined that after the alien's arrival he formed an intent to remain in the United States indefinitely, the intent persisting until his death

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There are a few cases dealing with aliens, however, that suggest that for certain purposes there can be a U.S. domicile without a state domicile. Elkins v. Moreno, 435 U.S. 647 (1978), *modified on other grounds sub nom.* Toll v. Moreno, 441 U.S. 458 (1979); Stadtmuller v. Miller, 11 F.2d 732 (2d Cir. 1926). Both *Elkins* and *Stadtmuller* involved the determination of an alien's status as a domiciliary of the United States. Thus, as federal law governed in this context, it was not necessary to find state domicile.

83. Treas. Reg. § 20.0-1(b).
84. *Id.*
85. Estate of Nienhuys v. Comm'r, 17 T.C. 1149, 1161 (1952), *acq.*, 1952-1 C.B. 3.
86. Rev. Rul. 74-364, 1974-2 C.B. 321.
87. Rev. Rul. 80-363, 1980-2 C.B. 249.

in 1978. The ruling cites *Elkins v. Moreno*[88] as authority that under federal law a nonimmigrant alien holding a nonimmigrant "G-4" visa has the legal capacity to establish a domicile within the United States. In *Elkins*, the Supreme Court concluded that if the visa classification did not impose restrictions on the intent or duration of stay, the alien could, under certain circumstances, adopt the United States as his domicile.[89]

§ 2:4 Estate Taxation of Resident Aliens

A resident alien is taxed in the same manner as a U.S. citizen for estate tax purposes.[90] This section, therefore, gives a brief overview of the statutory and case law on the taxation of U.S. citizens to provide a better understanding of the federal estate tax system and to alert the planner to potential problems.[91]

Prior to the Tax Act of 2001, a unified estate and gift tax system had been established by the 1976 Act and amended by the Economic Recovery Tax Act of 1981 (ERTA).[92] The Tax Act of 2001 made significant changes to federal transfer taxes. Under the Act, the federal estate tax (together with the federal generation-skipping transfer tax) was gradually reduced from 2002 through 2009 and then repealed in 2010.

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88. Elkins v. Moreno, 435 U.S. 647 (1978), *modified on other grounds sub nom.* Toll v. Moreno, 441 U.S. 458 (1979).

89. *See also* Rev. Rul. 80-209, 1980-2 C.B. 248. Revenue Ruling 80-209 is consistent with *Elkins* and vitiated Revenue Ruling 74-364 without revoking it. The ruling involved an alien who was in the United States illegally. Although the illegal alien could have been deported at any time, it was held that his activities were of such a nature (he had purchased real property in the United States and lived here with his family for many years) that he had established his domicile in the United States. *See also* Estate of Jack, 54 Fed. Cl. 590 (2002) (granting the IRS's motion for partial summary judgment and denying the estate's motion for partial summary judgment, thereby allowing the IRS an opportunity to submit evidence that a Canadian citizen, admitted to the United States on a temporary visa at the time of his death, was legally capable of forming the intent to be domiciled in the United States for U.S. federal estate tax purposes even though it was in violation of the terms of his visa).

90. The American Bar Association had proposed a definition for the term "domiciled alien" for estate and gift tax purposes. Currently, however, neither that proposal nor any similar proposals are the subject of the active discussion.

91. For greater detail, see, *e.g.*, R. STEPHENS, G. MAXFIELD, S. LIND & D. CALFEE, FEDERAL ESTATE AND GIFT TAXATION (8th ed. 2001) [hereinafter STEPHENS, MAXFIELD].

92. Pub. L. No. 97-34, 95 Stat. 172. The 1976 Act substantially changed the approach to federal estate and gift taxation by unifying what had previously been separate gift and estate taxes and by adding a new transfer tax known as the generation-skipping transfer tax. ERTA effectuated further changes (including introducing the unlimited marital deduction), but retained the unified approach.

Although the Act did not repeal the federal gift tax, the top gift tax rate declined together with the top estate tax rate through 2009. In addition, beginning in 2004, the Act distinguished between the exclusion amount applicable for lifetime transfers and transfers upon death (the applicable exclusion amount). From 2004 to 2009, the applicable exclusion amount for transfers upon death increased from $1,500,000 to $3,500,000, while the applicable exclusion amount for lifetime transfers remained fixed at $1 million. Although the Tax Act of 2001 repealed the federal estate tax (together with the federal generation-skipping transfer tax) in 2010, the Tax Act of 2001 contained a "sunset" provision which provided that it did not apply for tax years beginning after December 31, 2010.

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Act of 2010"). The Tax Act of 2010 retroactively reinstated the federal estate tax as of January 1, 2010, with a unified estate and gift tax exemption of $5,000,000 and a 35% maximum federal estate tax rate for decedents dying in 2010, 2011 or 2012. The estate of a decedent dying in 2010 may elect out of the federal estate tax regime, in which case property acquired from a decedent will not receive a step-up in basis and a modified carryover basis regime will apply for federal income tax purposes.

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 (the "Tax Act of 2012").[93] The Tax Act of 2012 raised the top estate and gift tax rate to 40% and provides for a unified estate and gift tax exemption of $5,000,000.[94]

Under current law, almost all taxable transfers, whether inter vivos or testamentary, are taken into account for purposes of computing the estate tax, which is based on the same rate table for both estate and gift tax purposes.

§ 2:4.1 Computation of Tax

To avoid double taxation, a tentative tax is calculated by applying the federal estate and gift tax rate schedule to the aggregate cumulative taxable lifetime transfers after 1976 (other than those that qualified for the annual exclusion[95] and other than gifts includible

93. Pub. L. No. 112-240, 126 Stat. 2313 (2013).

94. The unified gift and estate tax exemption amount is indexed for inflation and in 2014 is $5,340,000. Under the Tax Act of 2012, the generation-skipping transfer tax is imposed at a flat rate of 40% with an exemption amount of $5,000,000 (this amount is indexed for inflation and in 2014 is $5,340,000). Rev. Proc. 2013-35, 2013-2 C.B. 537.

95. I.R.C. § 2503(b). In the case of gifts made after 1998, the annual gift tax exclusion amount is $10,000 increased by an inflation adjustment amount (in 2014, the exclusion amount is $14,000). *See infra* note 111.

in the gross estate) and the taxable estate. The tentative tax is then reduced by subtracting any gift taxes paid (including those attributable to includible gifts within three years of death) on gifts made after December 31, 1976, and certain credits. These credits consist of the credit for the applicable exclusion amount to the extent not previously used for lifetime gifts, the credits for gift taxes on gifts prior to 1977 that are includible in the estate, the credit for prior transfer taxes, and the credit for foreign death taxes. Adding the cumulative taxable lifetime transfers (that is, "grossing up" the estate) causes a higher rate of tax to apply to the transfers occurring at death.

The credit for the applicable exclusion amount is used first to offset any gift taxes on taxable lifetime transfers and, to the extent so used, will not be available to offset estate taxes. If none of the credit for the applicable exclusion amount is used for gift tax purposes, the entire amount is available for estate tax purposes. In such a case there is no federal estate tax on a resident alien's estate if, after subtracting the relevant deductions, his taxable estate does not exceed the credit for the applicable exclusion amount.

§ 2:4.2 Gross Estate and Value

The gross estate of a citizen or resident alien is determined by the fair market value of his property at the date of death, or six months thereafter if the personal representative elects the alternate valuation date.[96] If the alternate valuation date is elected and property is sold or distributed before then, its value at the date of sale or distribution is includible in the gross estate.[97] For valuation purposes, the date of death of a resident alien is the prevailing date in the United States if he dies in a different time zone.[98] Such property includes any beneficial interests owned by the alien[99] and may also include interests transferred (in trust or otherwise) by the resident alien during his lifetime.

The Code protects against attempted estate tax avoidance by certain property transfers to persons or to inter vivos trusts. Examples of such avoidance include certain transfers made within three years of

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96. I.R.C. § 2032. If estate property is distributed, sold, exchanged, or otherwise disposed of within six months of the date of the decedent's death, such property should be valued as of the date of distribution, sale, exchange, or other disposition. *Id.* § 2032(a)(1).
97. See *id.* §§ 2031–46 for a determination of what is includible in the resident alien's estate.
98. Rev. Rul. 74-424, 1974-2 C.B. 294, *modifying* Rev. Rul. 66-85, 1966-1 C.B. 213.
99. I.R.C. § 2033; Treas. Reg. § 20.2033-1(a).

the death of the transferor or transfers in which the transferor retains a substantial degree of control over, or enjoyment of, the property transferred.

Code sections 2036, 2037, and 2038 generally provide that an estate tax will be imposed upon property transferred at any time during the transferor's life if he retains either the economic benefit of the property or significant powers over its possession or enjoyment, or if the transfer is essentially testamentary. These sections are frequently referred to as "string sections." As one judge has observed, however, "the cost of holding onto the strings may prove to be a rope burn."[100] Because sections 2035–38, as well as section 2041, are important in the international context, they are quoted and discussed in detail.

§ 2:4.3 Section 2035

§ 2035. Adjustments for certain gifts made within 3 years of decedent's death.

(a) Inclusion of certain property in gross estate. If—

(1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and

(2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

(b) Inclusion of gift tax on gifts made during 3 years before decedent's death.—The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

(c) Other Rules Relating to Transfers Within 3 Years of Death.—

(1) In general.—For purposes of—

(A) section 303(b) (relating to distributions in redemption of stock to pay death taxes),

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100. Old Colony Trust Co. v. United States, 423 F.2d 601, 605 (1st Cir. 1970).

(B) section 2032A (relating to special valuation of certain farms, etc., real property), and

(C) subchapter C of chapter 64 (relating to lien for taxes),

the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(2) Coordination with Section 6166.—An estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate meets such requirement both with and without the application of subsection (a).

(3) Marital and Small Transfers.—Paragraph (1) shall not apply to any transfer (other than a transfer with respect to a life insurance policy) made during a calendar year to any donee if the decedent was not required by section 6019 (other than by reason of section 6019(2)) to file any gift tax return for such year with respect to transfers to such donee.

(d) Exception.—Subsection (a) and paragraph (1) of subsection (c) shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

(e) Treatment of certain transfers from revocable trusts.—For purposes of this section and section 2038, any transfer from any portion of a trust during any period that such portion was treated under section 676 as owned by the decedent by reason of a power in the grantor (determined without regard to section 672(e)) shall be treated as a transfer made directly by the decedent.

With minor exceptions (including insurance interests), a decedent's gross estate will include only the value of property transferred by the decedent, in trust or otherwise, during the three-year period immediately prior to and ending on the date of the decedent's death, together with any gift tax paid thereon, if the property transferred would otherwise have been included in his gross estate by virtue of retained interests covered by Code sections 2036, 2037, 2038, and 2042. Consequently, many other gifts made during the three-year period are not included in the decedent's estate unless they are taxable gifts, in which case they will be taken into account by "grossing up" the tax base.

Section 2035 does not apply to transfers that are bona fide sales for adequate and full consideration or to any gift made by the decedent if the transferor is not required by section 6019 (other than by section

6019(2)) of the Code to file a gift tax return.[101] For instance, if a resident alien creates an irrevocable trust within three years of his death and retains an income interest in the trust, the value of the principal of the trust at the date of the alien's death (or alternate valuation date) is includible in his estate under section 2035 (as well as under section 2036) of the Code.[102]

§ 2:4.4 Section 2036

§ 2036. Transfers with retained life estate

(a) General rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

(b) Voting rights.—

(1) In general.—For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

(2) Controlled corporation.—For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318),[103] or had the right (either alone or

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101. Generally, I.R.C. § 6019 requires a U.S. federal gift tax return to be filed by any individual who, subject to certain exceptions, makes a transfer by gift which (i) does not qualify for the marital deduction, (ii) does not qualify for the charitable deduction, (iii) is greater than the § 2503(b) annual exclusion amount of $10,000 as adjusted for inflation ($14,000 in 2014), or (iv) is not a qualifying medical or educational expense.
102. I.R.C. §§ 2035(a), 2036(a).
103. I.R.C. § 318 refers to the attribution of stock ownership between certain family members.

in conjunction with any person) to vote stock possessing at least 20 percent of the total combined voting power of all classes of stock.

(3) **Coordination with section 2035.—**For purposes of applying section 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.

(c) **Limitation on application of general rule.—**This section shall not apply to a transfer made before March 4, 1931; nor to a transfer made after March 3, 1931, and before June 7, 1932, unless the property transferred would have been includible in the decedent's gross estate by reason of the amendatory language of the joint resolution of March 3, 1931 (46 Stat. 1516).

This section pertains to situations in which a person gives away property but retains for his lifetime the possession or enjoyment of the property or the right to its income or the right to control who shall possess or enjoy the property or its income. Thus, in such instances, the person has not given up the economic benefit or control of the property and is considered the property owner for federal estate tax purposes.

The control of property may occur in many different ways and is frequently disguised. The intent of the section is clear, however, and was reinforced by the addition of section 2036(b) in 1976. Section 2036(b) requires the inclusion of the value of stock of certain corporations when voting rights are retained by the decedent. The provision was a direct response to a Supreme Court decision in *United States v. Byrum.*[104] In that case, the stock of a closely held corporation was not included in the decedent's gross estate even though the decedent, after irrevocably transferring the stock in trust, reserved the power:

- to remove the trustee and appoint another corporate trustee;
- to vote the stock;
- to veto the sale or other transfer of the trust property; and
- to veto any change in investments.

Congress concluded that voting rights of corporate stock are so significant that their retention by a donor should be treated as the retention of the enjoyment of the stock itself for federal estate tax purposes.

For the value of the transferred property to be taxable, the decedent must retain an interest in the property for one of three prescribed

104. United States v. Byrum, 408 U.S. 125, *reh'g denied*, 409 U.S. 898 (1972).

periods: "his life," "any period not ascertainable without reference to his death," or "any period which does not in fact end before his death."[105]

An interest for life is retained when a person transfers property in trust and provides for the income to be paid to him for his life and, at his death, for the corpus to be distributed to named beneficiaries.

The other two such periods do not pertain to the retention of a straight life interest. For example, a trust agreement might provide that the decedent receives income payable quarterly for his life but not for the quarter in which he dies. Technically, his interest is not "for life," but its termination cannot be determined without reference to the date of his death. Therefore, the value of the property transferred is includible in his gross estate.[106] Or, for example, the decedent retains an interest for a specified time and dies within that time period.

Section 2036 applies if a decedent retains for himself either a beneficial interest in the transferred property or control over the beneficial interest of others. An interest or right is retained if at the time of the transfer there is an express or implied understanding that the interest or right will later be conferred.[107] Thus, if a father transfers his house to his son with the understanding that the father will live there until his death, rent free, the value of the home is includible in the father's estate.[108]

If the interest retained is a natural one, such as the co-occupancy of a house by a transferor-husband and a transferee-wife, the value of the property transferred is not includible in the gross estate of the husband in the absence of an implied agreement between the parties that the use of the property was reserved for the husband's life. Courts have generally refused to infer such an understanding simply from the fact of continued residence in the house by the transferor.[109] Also, a decedent retains an interest in income not only when he has a right to receive the income

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105. I.R.C. § 2036(a).

106. Treas. Reg. § 20.2036-1(b)(1)(i). *See* Bayliss v. United States, 326 F.2d 458 (4th Cir. 1964); Estate of Marshall v. Comm'r, 49 T.C.M. 1547 (1985).

107. Treas. Reg. § 20.2036-1(a)(ii).

108. Rev. Rul. 70-155, 1970-1 C.B. 189:

> [E]njoyment as used in the death tax statute . . . is synonymous with substantial present economic benefit . . . An understanding or agreement, expressed or implied, as to the donor's retained use of the transferred property is sufficient to bring the transfer within the provisions of section 2036.

This position was upheld by Guynn v. United States, 437 F.2d 1148 (4th Cir. 1971). *See* Haneke v. United States, 548 F.2d 1138 (4th Cir. 1977).

109. *See, e.g.*, Estate of Binkley v. United States, 358 F.2d 639 (3d Cir. 1966).

directly, but also when he has a right to use the income for his benefit, such as to fulfill a legal obligation[110] or to support a dependent.

Section 2036 also applies if a decedent transferor retains "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[111] Such a right exists even if the decedent only has the authority to choose between two named beneficiaries.[112] It is immaterial whether the proscribed power is exercisable by the decedent alone or in conjunction with another person or persons, whether its exercise is subject to a contingency beyond the decedent's control that does not in fact occur before his death, or in what capacity the power is exercisable by the decedent.[113]

Section 2036 does not apply to a power exercisable solely by a person other than the decedent unless the decedent retains the unrestricted power to remove that person and succeed to that power, as by retaining the right to remove a trustee with such power and appointing a related or subordinate party (within the meaning of I.R.C. section 672(c)) or himself, as trustee.[114]

The amount included in the decedent's estate is the value of the interest retained or controlled by the decedent at the applicable valuation date, either the date of death or the alternate valuation date. This amount is included because, for estate tax purposes, the transfer is treated as a testamentary disposition (the decedent, in effect, having postponed the effect of the transfer until his death).

The entire value of the transferred property is not includible if the decedent retained only a portion of the proscribed interest. For example, if a husband establishes a trust, 40% of the income of which is paid to the decedent's wife for her support and maintenance and the remaining 60% of which is paid to her children by a previous marriage, only 40% of the value of the trust corpus is includible in the husband's estate (assuming the local law imposes an obligation on the decedent to support his wife but does not impose a corresponding obligation to support his wife's children).[115]

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110. Treas. Reg. § 20.2036-1(b)(2).
111. Treas. Reg. § 20.2036-1(a)(3)(ii).
112. Indus. Trust Co. v. Comm'r, 165 F.2d 142, 145 n.2 (1st Cir. 1947).
113. Treas. Reg. § 20.2036-1(b)(3).
114. Rev. Rul. 77-182, 1977-1 C.B. 273, *modified*, Rev. Rul. 95-58, 1995-2 C.B. 191, which held that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinated (within the meaning of I.R.C. § 672(c)) to the decedent, the decedent would not be deemed to have retained a trustee's discretionary control over trust income.
115. Comm'r v. Estate of Dwight, 205 F.2d 298 (2d Cir.), *cert. denied*, 346 U.S. 871 (1953).

Moreover, if the decedent creates an interest unaffected by the interest retained by him, the value of such an "outstanding interest" is excluded. For example, if the decedent's right to income arises only upon the termination of another's life interest, the amount included is the value of the property transferred, reduced by the value of the outstanding life interest, as of the decedent's date of death.[116]

§ 2:4.5 Section 2037

§ 2037. Transfers taking effect at death

(a) General rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time after September 7, 1916, made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, if—

(1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and

(2) the decedent has retained a reversionary interest in the property (but in the case of a transfer made before October 8, 1949, only if such reversionary interest arose by the express terms of the instrument of transfer), and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.

(b) Special rules.—For purposes of this section, the term "reversionary interest" includes a possibility that property transferred by the decedent—

(1) may return to him or his estate, or

(2) may be subject to a power of disposition by him, but such term does not include a possibility that the income alone from such property may return to him or become subject to a power of disposition by him. The value of a reversionary interest immediately before the death of the decedent shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, under regulations prescribed by the Secretary. In determining the value of a possibility that property may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such property may return to the decedent or his estate. Notwithstanding

116. *See, e.g.*, Marks v. Higgins, 213 F.2d 884 (2d Cir. 1954).

> the foregoing, an interest so transferred shall not be included in the decedent's gross estate under this section if possession or enjoyment of the property could have been obtained by any beneficiary during the decedent's life through the exercise of a general power of appointment (as defined in section 2041) which in fact was exercisable immediately before the decedent's death.

Under section 2037, the value of property transferred conditionally during the decedent's life is includible in his gross estate only if the following two requirements are met: (1) the beneficiary can obtain possession or enjoyment of the property *only* by surviving the decedent-transferor and (2) the decedent-transferor has retained a reversionary interest exceeding 5% of the value of the property immediately before death.

If the beneficiary can obtain possession or enjoyment while the transferor is still living, section 2037 is inapplicable. Thus, if possession or enjoyment is contingent upon either the decedent-transferor's death or the occurrence of some other event, such as the expiration of a term of years, section 2037 is generally inapplicable.

For example, if a trust provides for the payment of income to the decedent-transferor, *A*, for ten years or until *A*'s death, whichever occurs first, with the remainder to a named beneficiary, *B*, the value of the property is not includible in *A*'s estate because *B* could obtain possession while *A* is still alive. That *A* might die before the expiration of the ten-year period is irrelevant because the concept present in section 2036, regarding a "period which does not in fact end before" the decedent's death, is not present in section 2037.[117]

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117. Treas. Reg. § 20.2037-1(b). The Regulation provides that if an event other than survivorship is "unreal" and the death of the decedent in fact occurs before the event, "the beneficiary will be considered able to possess or enjoy the property only by surviving the decedent." Example (5) of Treas. Reg. § 20.2037-1(e) gives an example that differentiates between a "real" and an "unreal" condition:

> The decedent transferred property in trust with the income to be accumulated for a period of 20 years or until the decedent's prior death, at which time the principal and accumulated income was to be paid to the decedent's son if then surviving. Assume that the decedent does, in fact, die before the expiration of the 20-year period. If, at the time of the transfer, the decedent was 30 years of age, in good health, etc., the son will be considered able to possess or enjoy the property without surviving the decedent. If, on the other hand, the decedent was 70 years of age at the time of the transfer, the son will not be considered able to possess or enjoy the property without surviving the decedent.

As for the second requirement, section 2037(b) defines "reversionary interest" as including a possibility that the property may return to the decedent or his estate, or may be subject to a power of disposition by him. This requirement is satisfied by the mere existence of such a possibility; it is not necessary to show that the property in fact must return. For example, if *A* transfers property to a trust that provides for the income to be paid to *B* for life and, upon *B*'s death, for the corpus to be distributed to *A* if living and, if not, to *C* or *C*'s estate, *A* has the requisite reversionary interest even though it is cut off by *A*'s death if he is survived by *B*.[118]

For the requirement to be satisfied, the decedent-transferor must have retained such an interest at the time of transfer. The mere possibility that such an interest may be obtained by the decedent-transferor is not sufficient. For example, if a decedent-transferor provides that at the termination of an inter vivos trust the property is to pass to his wife or to her estate, the fact that he may be entitled to share in her estate does not mean that he retained a reversionary interest in the transferred property. The possibility of the return of the property to the decedent must arise directly by his own action.[119]

Section 2037(b) provides for an exception to includibility if the transferred property is subject to the exercise of a general power of appointment during the decedent-transferor's life, which power is exercisable immediately before his death. It is not necessary that the person to whom the property is transferred have the power. This point is illustrated by example (6) to section 20.2037-1(e) of the Treasury Regulations:

> The decedent transferred property in trust with the income to be accumulated for his life and, at his death, the principal and accumulated income to be paid to the decedent's then surviving children. The decedent's wife was given the unrestricted power to alter, amend, or revoke the trust. Assume that the wife survived the decedent but did not, in fact, exercise her power during the decedent's lifetime. Since possession or enjoyment of the property could have been obtained by the wife during the decedent's lifetime under the exercise of a general power of appointment, which

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118. *See* Estate of Tarver v. Comm'r, 255 F.2d 913 (4th Cir. 1958), where the decedent established a trust for one of his daughters but provided that if, at his death, he had not established trust funds of at least equal amounts for his other daughters and the net value of his estate was greater than a specified amount, the corpus of the trust was to pass under the residuary clause of his will. The court held that he had retained a reversionary interest in the property. *See also* Costin v. Cripe, 235 F.2d 162 (7th Cir. 1956).

119. *See* Treas. Reg. § 20.2037-1(c)(2).

was, in fact, exercisable immediately before the decedent's death, no part of the property is includible in the decedent's gross estate.

[A] Value of Reversionary Interest

For the value of the property to be included in the decedent-transferor's gross estate, his reversionary interest must exceed 5% of the value of the property transferred. The value of the decedent's reversionary interest is determined as of the time immediately preceding the decedent's death; the fact of the decedent's death is disregarded in such determination. The value is determined according to the mortality tables and actuarial principles set forth in the regulations for section 2031.[120] This determination involves the computation of the decedent's mathematical chances, on the basis of his age immediately prior to death, of surviving certain contingent events, such as the deaths of named beneficiaries or the expiration of a term of years.

In determining whether the value of the reversionary interest exceeds 5%, it must be compared with the entire value of the transferred property, including interests not dependent upon survivorship of the decedent. If a decedent retains a reversionary interest in only one-half of the trust corpus, the value of that interest is compared with the value of one-half of the corpus.

If section 2037 applies, it is not just the value of the decedent's reversionary interest that is included in his estate. The value on the applicable valuation date of any interest in property transferred in such a manner as to take effect in possession or enjoyment only after the transferor's death is also includible. Thus, assume *A* establishes a trust to pay income to *B* for his life and at *B*'s death to distribute the corpus to *A*, if living, and, if not, to *C* or *C*'s estate. Assume *B* and *C* survive *A*. The value of *B*'s income interest is not includible because he obtains possession and enjoyment without regard to *A*'s death. The value of *C*'s remainder interest is includible, however, because neither *C* nor the beneficiaries of his estate can possess or enjoy that interest unless they survive *A*.

[B] Overlap Between Sections 2036 and 2037

There is some overlap between sections 2036 and 2037. Clearly, retention by the decedent-transferor of a life interest in the transferred property under section 2036 imposes the condition of survivorship upon those holding remainder interests. Similarly, the requirement under section 2037 that a remainderman survive the decedent-transferor postpones for the decedent-transferor's lifetime the complete "enjoyment" of that property by the remainderman. The major distinction

120. *See* Treas. Reg. § 20.2031-1, § 20.2031-7, § 20.2031-7A.

between the two sections is the requirement of section 2037 that the decedent have a reversionary interest in the transferred property exceeding 5%. In the following examples illustrating the overlap, it is assumed that the decedent's reversionary interest exceeds 5%.

> *A* creates a trust to pay himself the income for life, remainder to *B*, but if *B* predeceases *A*, remainder to *A*'s estate.

Under section 2036(a)(1), the value of the entire property transferred is includible in *A*'s estate because *A* retains a life estate. Similarly, under section 2037, the value of the entire property is includible in *A*'s estate because the survivorship and 5% reversionary interest tests are met.

> *A* creates a trust to pay the income to himself for ten years and at the end of the ten-year period, remainder to *C*, if living, or, if not, to *A* or *A*'s estate. If *A* were to die before ten years elapsed, income to *B* for the balance of the ten-year term. *A* dies after six years.

Under section 2036(a)(1), the value of the entire property transferred is includible in *A*'s estate because he retains the enjoyment of the property for a period that does not in fact end before his death. Under section 2037, the value of *B*'s four-year income interest is includible in *A*'s estate because of *A*'s reversionary interest. The value of *C*'s remainder interest is not includible, however, since *C* need not survive *A* to take possession of his interest. In determining the amount of estate tax, the IRS would proceed under section 2036(a)(1) because it produces the greatest tax.

§ 2:4.6 *Section 2038*

§ 2038. Revocable transfers

(a) In general.—The value of the gross estate shall include the value of all property—

(1) Transfers after June 22, 1936.—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during

the 3-year period ending on the date of the decedent's death.

(2) Transfers on or before June 22, 1936.—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death. Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

(b) Date of existence of power.—For purposes of this section, the power to alter, amend, revoke, or terminate shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the alteration, amendment, revocation, or termination takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised. In such cases proper adjustment shall be made representing the interests which would have been excluded from the power if the decedent had lived, and for such purpose, if the notice has not been given or the power has not been exercised on or before the date of his death, such notice shall be considered to have been given, or the power exercised, on the date of his death.

Section 2038, like section 2036, causes the value of property previously transferred to be includible in the decedent-transferor's estate if he retains the power to alter, amend, revoke, or terminate the gift.[121] As such a power permits the decedent to exercise control

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121. Subsection (a) of section 2038 distinguishes between transfers made on or before June 22, 1936, and those made after that date. There are four differences in the language applicable to the respective transfers. Two of the differences—the addition of the word "terminate" and the parenthetical phrase, "in whatever capacity exercisable," to subparagraph (1)—are merely formal. The other two differences are substantive. The first is that the value of property transferred on or before June 22, 1936, would be includible in the decedent-transferor's estate only if he relinquishes the

over the property, as well as its economic benefits, until the time of his death, it is taxable.

Any power retained by the decedent to alter, amend, revoke, or terminate the enjoyment of a transferred interest in property will result in the application of section 2038. The broadest of the proscribed powers is the power to revoke. For section 2038 to apply to a transfer, it is not necessary for the power of revocation to be expressly retained so long as the transfer is in fact revocable. For example, if state law provides that a voluntary trust is revocable unless expressly made irrevocable, a trust agreement silent on revocability is within the scope of section 2038.[122]

A power to alter or amend the beneficial interests in the transferred property is within the purview of section 2038, whether the power is exercised by the decedent or the exercise of the power benefits the decedent. This power includes the power not only to add new beneficiaries to the trust, but also to change the proportionate interests of existing beneficiaries. Thus, in *Florida National Bank v. United States*,[123] the value of property transferred was held includible in the decedent-transferor's estate because he retained the power to make changes with respect to the distribution of principal and income to his

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proscribed power within the statutory three-year period. The value of property transferred after that date is includible if the proscribed power is relinquished within the statutory three-year period, regardless of who actually relinquished it. For example, assume the decedent-transferor retains a power exercisable with the consent of *A*. Further, assume *A* relinquishes the power within three years of the decedent-transferor's death and under local law such relinquishment nullifies the decedent's power. Under such circumstances, the property over which the power is exercisable is includible in the decedent-transferor's estate if the transfer is made after June 22, 1936, but not if it is made before June 23, 1936. Treas. Reg. § 20.2038-1(e)(2).

The second substantive difference is that transfers made after June 22, 1936, are taxable "without regard to when or from what source the decedent acquires such power," whereas earlier transfers are taxable only if the decedent actually retains the requisite power. The addition of the provision was prompted by the Supreme Court's decision in White v. Poor, 296 U.S. 98 (1935). The Court decided that because the decedent-transferor's power resulted not from an express reservation in the trust agreement but from the decedent's reappointment as trustee after the resignation of another trustee, the trust's principal was not includible in the decedent-transferor's estate even though the decedent-transferor had held the power earlier as one of the original trustees.

122. *See, e.g.*, Estate of Casey v. Comm'r, 55 T.C. 737 (1971).

123. Fla. Nat'l Bank v. United States, 336 F.2d 598 (3d Cir. 1964), *cert. denied*, 380 U.S. 911 (1965).

children even though he expressly denied himself the power to make any appointment in favor of himself or his estate.[124]

Generally, a cumulation of administrative powers, such as the right to invest trust corpus or allocate receipts and disbursements between principal and income, will not suffice to cause the trust property to be includible in the transferor's estate, especially if the power is subject to a fiduciary standard.[125]

A power to terminate a trust is clearly within the purview of section 2038. Although a power to terminate usually affects all beneficial interests and, thus, causes the entire corpus to be within the gross estate, in some situations not all the interests transferred are includible. For example, assume that *A* creates a trust, the income of which is payable to *B* for life, remainder to *C* or *C*'s estate, but *A* reserves a power to direct the remainder to *D* (and thus terminate *C*'s interest). Only the value of the remainder interest is includible in *A*'s estate if he dies with the power, because, if it is exercised, *B*'s life estate remains unaffected.[126]

Assume the decedent-transferor established a trust, the income of which is payable to a beneficiary for a term of years, and the remainder of which is payable to the same beneficiary at the expiration of that term. Also, assume that the decedent retains the power to accelerate the beneficiary's enjoyment of the remainder by terminating the trust and distributing the corpus to him. In that event, the remainder interest is includible in the decedent's estate under section 2038 even though the exercise of the power can only benefit the same beneficiary.

In *Lober v. United States*,[127] the decedent transferred to himself, as trustee, certain property for the benefit of his children. Under an irrevocable trust instrument, the decedent could accumulate and reinvest the income from each separate trust for a child until the respective child attained the age of twenty-one, at which time the child was to be paid the accumulated income from his trust; the decedent

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124. *See also* Union Trust Co. v. Driscoll, 138 F.2d 152 (3d Cir. 1943), *cert. denied*, 321 U.S. 764 (1944).

125. In Old Colony Trust Co. v. United States, 423 F.2d 601, 603 (1st Cir. 1970), it was held that "no aggregation of purely administrative powers" (including, in this case, discretion to acquire investments not normally held by trustees) over the corpus by the trustee, of whom the decedent was one, could meet the government's proposed test of "sufficient dominion and control" so as to be equated with ownership.

126. *See, e.g.*, Walter v. United States, 341 F.2d 182 (6th Cir. 1965); *see also* Rev. Rul. 70-513, 1970-2 C.B. 194.

127. Lober v. United States, 346 U.S. 335 (1953).

could hold the principal until the child reached the age of twenty-five, at which time it was to be paid to the child. Also, the decedent could, at any time, pay over all (or part of) the principal to the child for whom the separate trust was held.

Although the decedent could in no way invade the trusts' principal for himself, the Court held that a "donor who keeps so strong a hold over the actual immediate enjoyment of what he put beyond his own power to retake has not divested himself of that degree of control which section 811(d)(2) [of the 1939 Code, the predecessor of current section 2038] requires in order to avoid the tax."[128]

If the power to alter, amend, revoke, or terminate is held solely by a person other than the decedent, section 2038 does not apply unless the decedent has the unrestricted power to remove that person and appoint himself in such capacity.[129] Also, section 2038 does not apply to a transfer if the decedent-transferor's discretion to determine income payments is limited by an ascertainable, objective standard.

In a leading case, *Jennings v. Smith*,[130] the court held that the decedent-transferor's power to pay out as much income as was necessary for the beneficiary to keep himself and his family in comfort "in accordance with the status in life to which he belongs" was not sufficiently broad to cause the trust's corpus to be includible under section 2038. If, however, the decedent-transferor were a trustee given the power, in the event of the beneficiary's "special need," to pay to the beneficiary as much as the trustee, in the trustee's sole discretion, deems advisable, the transfer would be taxable.[131]

Trust instruments authorizing the transferor-trustee to distribute, in his discretion, trust corpus for the "happiness," "pleasure," "reasonable requirements," or "best interests" of the beneficiary contain standards that have been held so loose that the trustee's power is virtually uncontrolled. The value of property transferred under such instruments, therefore, is includible in the gross estate of the decedent-transferor.[132]

Powers exercisable by the decedent alone or in conjunction with any other person, regardless of whether the co-holder of the power has an interest that would be adversely affected by its exercise, are within the

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128. *Id.* at 337.
129. Treas. Reg. § 20.2038-1(a)(3).
130. Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).
131. Rev. Rul. 73-143, 1973-1 C.B. 407, states that such a provision would be too broad to constitute an ascertainable standard and, therefore, would not sufficiently limit the trustee's powers to vary the beneficiary's trust interests.
132. *See* Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970).

scope of section 2038.[133] The property is not includible, however, if the decedent's power can be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law.[134]

Section 2038 applies only if a proscribed power exists at the date of the decedent-transferor's death. For purposes of section 2038, a power is considered to exist at the date of death if its exercise is subject only to giving notice or if the change effectuated by the exercise is to occur only upon the expiration of a stated period regardless of whether notice is given or the power exercised on or before the date of the decedent's death. If, however, the power is contingent upon the happening of a certain event, and that event has not in fact happened, the decedent does not have the power at his death and the transfer is not taxable.[135]

§ 2:4.7 Overlap Between Sections 2038 and 2036

There is a substantial amount of overlap between sections 2038 and 2036. A common example of a transfer to which both sections 2036 and 2038 apply is the following:

> *A* creates a trust under which the income is paid to *B* for life, remainder to *C* or his estate. *A* retains the power to invade the corpus for the benefit of *C*.

Because *A* retains the right to designate who can enjoy the property, section 2036(a)(2) provides for the inclusion of the entire value of the transferred property in *A*'s gross estate. Section 2038 also is applicable because both *B*'s income interest and *C*'s remainder interest may be modified through an exercise of *A*'s power. Thus, the entire value of the property transferred is includible in *A*'s gross estate under either section.

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133. *See* Helvering v. City Bank Farmers Trust Co., 296 U.S. 85, *reh'g denied*, 296 U.S. 664 (1935) (holding that property transferred pursuant to a trust instrument that provided that the transferor-trustee could modify, alter, or revoke the trust with the written consent of her husband, a beneficiary, was includible).

134. Treas. Reg. § 20.2038-1(a)(2). In Helvering v. Helmholz, 296 U.S. 93 (1935), the trust indenture provided that the trust would terminate upon the signed consent of all the then beneficiaries. The Court held that the value of the property transferred was not includible because of the general rule that all parties in interest may consensually terminate a trust. The clause, therefore, added nothing to the rights conferred upon the beneficiaries by law.

135. *See* Bank of N.Y. v. United States, 174 F. Supp. 911 (S.D.N.Y. 1957).

Often, sections 2036 and 2038 apply to the same transfer, but their application results in the inclusion of different amounts in the gross estate.[136] Generally, if a decedent retains a power of designation to which section 2036(a)(2) applies, the value of the entire property transferred (less the value of any outstanding income interest that is not subject to the decedent's interest and that is actually being enjoyed by another person at the time of the decedent's death) is includible in the decedent's estate. If a transfer is taxable under section 2038, however, only those interests whose enjoyment may be modified by the decedent at the time of his death through the exercise of a power are includible in his gross estate. For example:

> *A* transfers property in trust, income to *B* for life, then to *C* and *D* during their joint lives. Upon the death of *C* or *D* all the income goes to the survivor during his life, remainder to *E*. *A* retains a power to alter the income interests of *C* and *D*.

It is clear that both sections 2036(a)(2) and 2038 apply to the transferred property. Under section 2036(a)(2), however, the entire corpus is includible in *A*'s estate, while under section 2038 only the value, at *A*'s death, of the joint life interest of *C* and *D* is taxable because *A*'s power cannot affect *B*'s life interest. In such a case, the IRS would apply section 2036(a)(2) because that section affects a larger gross estate.

§ 2:4.8 Section 2041

§ 2041. Powers of appointment

(a) In general.—The value of the gross estate shall include the value of all property—

(1) Powers of appointment created on or before October 21, 1942.—To the extent of any property with respect to which a general power of appointment created on or before October 21, 1942, is exercised by the decedent—

(A) by will, or

(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive;

but the failure to exercise such a power or the complete release of such a power shall not be deemed an exercise

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136. Section 2036 does not apply to retained powers affecting only a remainder interest.

thereof. If a general power of appointment created on or before October 21, 1942, has been partially released so that it is no longer a general power of appointment, the exercise of such power shall not be deemed to be the exercise of a general power of appointment if—

(i) such partial release occurred before November 1, 1951, or

(ii) the donee of such power was under a legal disability to release such power on October 21, 1942, and such partial release occurred not later than 6 months after the termination of such legal disability.

(2) **Powers created after October 21, 1942.—**To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive. For purposes of this paragraph (2), the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised.

(3) **Creation of another power in certain cases.—**To the extent of any property with respect to which the decedent—

(A) by will, or

(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036 or 2037,

exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

(b) Definitions.—For purposes of subsection (a)—

(1) General power of appointment.—The term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that—

(A) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.

(B) A power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.

(C) In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person—

(i) If the power is not exercisable by the decedent except in conjunction with the creator of the power—such power shall not be deemed a general power of appointment.

(ii) If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent—such power shall not be deemed a general power of appointment. For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent's power.

(iii) If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person—such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of

such persons (including the decedent) in favor of whom such power is exercisable.

For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

(2) **Lapse of power.**—The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

(A) $5,000, or

(B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

(3) **Date of creation of power.—**For purposes of this section, a power of appointment created by a will executed on or before October 21, 1942, shall be considered a power created on or before such date if the person executing such will dies before July 1, 1949, without having republished such will, by codicil or otherwise, after October 21, 1942.

Under section 2041, a person who possesses a general power of appointment over property has the ability to determine the beneficial enjoyment of the property. Therefore, the value of the property is includible in his estate. A general power of appointment includes all powers, whether or not they are technically powers of appointment, that are in substance and effect like powers of appointment. For instance, the power to consume or appropriate property would be deemed a power of appointment. Powers may be exercisable during the life of the donee or upon his death. The determination of how a power may be exercised is generally dictated by the instrument creating the power.

Under section 2041(b)(1), a general power of appointment must be exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. Although there are certain exceptions to this rule, it is important to note that for tax purposes, a power of appointment is not a general power if (1) it is only exercisable in favor of one or more designated persons or class of persons other than the decedent or his creditors or the decedent's estate or the creditors of his

estate or (2) it is expressly not exercisable in favor of the decedent, his creditors, the decedent's estate, or the creditors of his estate.

The donee of a power of appointment does not have a property interest (in the traditional sense) in the property over which the power applies. Thus, if *A* creates a trust with the income to *B* and remainder to *C*, but gives *D* a power of appointment over the principal, *D* does not have a property interest in the trust by virtue of his power. If *D* exercises the power by directing the trustee to transfer the property to *E*, the property is deemed to pass from *A*, the grantor, to *E*, rather than from *D*, the donee of the power. Nevertheless, Congress concluded that the power to determine the beneficial owner of property (if the class of potential appointees includes the donee or his creditors) is sufficient to cause the power to be included in the estate of the donee. Practitioners sometimes speculate what would happen if a taxpayer were to give the Commissioner a general testamentary power and not inform him about it.

Technically, section 2041 could catch in its net powers that are not specifically powers of appointment, but act effectively as such powers. This seems to cause some duplication with sections 2036 and 2038, but the regulations indicate that section 2041 will not operate to exclude property includible in the decedent's estate because of other Code sections.[137] Thus, if *A* creates a trust for the benefit of *B* and reserves the right to revoke the trust, he has a power of disposition over the property like a power of appointment. The property, however, is includible not under section 2041 but under section 2038.

[A] Date of Creation

It is important to determine when a general power of appointment is created for purposes of section 2041. The critical date is October 21, 1942. Thus, for any general power created before October 22, 1942 (pre-1942 powers), only its exercise will result in taxation in the donee's estate. If the power is not exercised, or if it is released during the lifetime of the donee, no tax results.

If a donee of a post-October 21, 1942, general power (post-1942 power) holds the power until his death, however, the property is includible in his estate whether or not he exercises it. Here, possession is the important factor.

Further, if the donee of a post-1942 power exercises or releases it during his lifetime, a gift tax liability results. Estate tax liability results only if the exercise or release of the power is effected in such a manner that taxability would be triggered by sections 2035 through 2038 if the property were the decedent-donee's own property. For instance, if the exercise or the release of the power is such that the donee continues to

137. Treas. Reg. § 20.2041-1(b)(2).

retain the right to designate the persons who are to enjoy the principal or income of the property, the value of the property to which the power applies is includible in the decedent-donee's estate.

[B] Exceptions to Includibility in Estate

Certain exceptions to includibility apply. The value of the property subject to a post-1942 power, exercisable in favor of the donee, but limited by an ascertainable standard relating to the donee's health, education, support, or maintenance (or any combination thereof), is not taxable.[138] The difficult question is to determine if the power is, in fact, limited by a satisfactory ascertainable standard. A power exercisable for "comfort, welfare, or happiness" is not limited by such an ascertainable standard.[139] Thus, standards that are general or vague will not be satisfactory. Satisfactory standards are "support," "maintenance in health and reasonable comfort," "health," and "education, including college and professional education."[140] The regulations set forth a list of standards sufficiently varied to provide flexibility in family planning.

The second exception, relating to post-1942 powers, provides that if the power is exercisable in conjunction with another person, it is not a general power.

The third exception, relating to post-1942 powers, also applies to powers exercisable in conjunction with another person. If the decedent-donee can exercise the general power of appointment only in conjunction with the donor of the power, section 2036 and section 2038 cause the property to be included in the estate of the donor. To also include it in the estate of the donee would be unfair. In addition, if the decedent-donee can exercise the power only in conjunction with someone who has a substantial interest in the appointive property—an interest adversely affected by the exercise of the power in favor of the decedent-donee—it is not includible in his estate.

An interest adverse to the exercise of a power is considered substantial if its value in relation to the total value of the property subject to the power is not insignificant. The interest is valued actuarially. The adverse interest must be truly adverse in the economic sense for the condition to be met. For instance, a co-trustee would not have an interest sufficiently adverse, but someone with a present or future chance to benefit personally from the property has an adverse interest.

Finally, if the power is not exercisable by the decedent-donee except in conjunction with another person in whose favor the power also may be exercised, only the value of the portion of the property over which the decedent-donee has the power is treated as subject to the general

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138. Treas. Reg. § 20.2041-1(c)(2).
139. *Id.*
140. *Id.*

power of appointment and includible in his estate. This exception is overlapping. Presumably the person in whose favor it might be exercised has a substantial interest in the property. The reasoning seems to be that a person whose consent is necessary could insist upon receiving a portion of the property (for example, one-half). If, for instance, two additional people were joined in the exercise of the power, then only one-third of the property would be includible in the decedent-donee's estate.

[C] Release and Disclaimer

A release of a post-1942 general power is in effect an exercise of the power. If the power is released during the donee's lifetime, it is a taxable gift. A pre-1942 power, if released during the donee's lifetime (or if not exercised by will), is not deemed an exercise and is not includible. In the release of a post-1942 power, estate tax liability results if it causes the property to be disposed of in a manner which would cause taxability under sections 2035 through 2038.

A disclaimer or renunciation of a general power of appointment is not deemed a release of such power. If the power is created after 1976, the procedures and requirements of section 2518 must be followed for a disclaimer to be effective.

Contrary to prior law, under ERTA a disclaimer or renunciation need not be effective under local law. Under ERTA, a disclaimer that meets the federal requirements set out in section 2518 will be a "qualified disclaimer" for federal estate and gift tax purposes if the person who receives the property because of the disclaimer is the same person who would have received it if the disclaimer were valid under local law.

The disclaimer must be a complete and unqualified refusal to accept the rights to which one is entitled. To effect this result, there must be no acceptance of the power of appointment because once the power is accepted, it is not possible to disclaim it. In the absence of facts to the contrary, failure to disclaim a power created prior to 1977 within a reasonable period of time after learning of its existence is presumed to constitute acceptance.[141] For powers created after 1976,

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141. Treas. Reg. § 20.2041-3(d)(6)(ii). In a somewhat related but different context, namely that of a remainder interest, the Supreme Court settled an issue upon which the circuit courts had been divided. The Court held that disclaimers of interest created before 1977 must occur within a reasonable time after the remainderman learns of the interest, rather than within a reasonable time after the remainderman learns of the termination of the prior life estate. *See* Jewett v. Comm'r, 455 U.S. 305 (1982). *See also* discussion of qualified disclaimers under § 2518 immediately above and in chapter 4 at section 4:4.5.

section 2518 requires the donee to disclaim the power within nine months after its creation or after the donee reaches age twenty-one.

[D] Lapse of Power

Under section 2041(b)(2), the lapse of a post-1942 power during the donee's lifetime is equivalent to a release, subject to certain exceptions. For example, if an individual can draw on the principal of a trust each calendar year, but fails to exercise that right, he exercises his right by omission; for estate tax purposes, it is an exercise of the power in favor of the one who takes in default. An important exception, known as the "5-and-5" exception, is provided by section 2041(b)(2). If the lapse applies to a power that, if exercisable, is limited to the greater of $5,000 or 5% of the value of the property, it is not a release. Further, if the lapsed power exceeds such limitations, its lapse is treated as a release only to the extent of the excess. Thus, if a decedent-donee is able to invade the principal of a trust for his benefit to the extent of the 5-and-5 exception, and he never exercises the power, the lapse has no effect on his estate.

The 5-and-5 exception applies only to lapses during the decedent's life. Thus, if the decedent does not exercise any of his 5-and-5 power in the year in which he dies, he is deemed to have the power at his death, and the value of the property he could have obtained is includible in his estate. The 5-and-5 exception is not a cumulative right and must be exercised on an annual basis. The draftsman must thus address certain valuation problems, such as the time of year the trust should be valued to determine the worth of 5%.

It should be noted in considering a post-1942 general power that the value of the property over which the general power exists is included in the estate of the donee in the same manner as if he owned the property outright, that is, the date of death or alternate valuation date six months later. Also, except for the 5-and-5 exception, the property over which a general power applies is deemed to be the donee's property and sections 2035 through 2038 apply to be exercise or release of such a power during the donee's lifetime.

§ 2:4.9 Section 2043

§ 2043. Transfers for insufficient consideration

(a) In general.—If any one of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there

shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

(b) Marital rights not treated as consideration.—

(1) In general.—For purposes of this chapter, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration "in money or money's worth."

(2) Exception.—For purposes of section 2053 (relating to expenses, indebtedness, and taxes), a transfer of property which satisfies the requirements of paragraph (1) of section 2516 (relating to certain property settlements) shall be considered to be made for an adequate and full consideration in money or money's worth.

Sections 2035 through 2038 and section 2041 do not apply to transfers that are "a bona fide sale for an adequate and full consideration in money or money's worth," as provided under section 2043. To qualify as such a sale, however, the transfer must be made in good faith and the price must be an adequate and full equivalent of the property reducible to a money value.[142] The "reducible to a money value" requirement excludes, for example, any sentimental value the property may have to the transferor. Transfers for less than full and adequate consideration are includible in the decedent's gross estate to the extent that the fair market value of the transferred property at the applicable valuation date (date of death or six months thereafter) exceeds the value of the consideration received therefor by the decedent.

§ 2:4.10 Other Code Provisions

Three other Code provisions pertain to special types of property: annuities (section 2039), joint interests (section 2040), and proceeds of life insurance (section 2042). The provisions on annuities and proceeds of insurance are not often significant in international estate planning. Because there is an impact on executives who have certain corporate benefits and who become domiciled in the United States, a brief general discussion, relevant in some limited situations, follows. (For joint interests, see chapter 4.)

142. Treas. Reg. § 20.2043-1(a).

[A] Section 2039

§ 2039. Annuities

(a) General.—The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

(b) Amount includible.—Subsection (a) shall apply to only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent. For purposes of this section, any contribution by the decedent's employer or former employer to the purchase price of such contract or agreement (whether or not to an employee's trust or fund forming part of a pension, annuity, retirement, bonus or profit-sharing plan) shall be considered to be contributed by the decedent if made by reason of his employment.

Prior to amendments to section 2039 in 1984, there was a special $100,000 exclusion for annuities and other payments under qualified plans and certain contracts.[143] The $100,000 exclusion is still allowed for estates of decedents dying after 1984 if the decedent was receiving benefits under a qualified retirement plan or specified annuity contract on December 31, 1984, and who, before July 18, 1984, irrevocably elected the form of retirement benefits. Subsection 2039(c) before its amendment by DEFRA described annuities that were exempt from the provisions of section 2039(a) and (b). These included annuities that were payable to beneficiaries, other than the personal representative of the decedent, pursuant to certain trusts and plans. The exemptions were extraordinarily technical and generally applied only to trusts and plans of U.S. organizations that qualified for favorable income tax

143. *See* I.R.C. § 2039(g) prior to amendment by DEFRA, Pub. L. No. 98-369, § 525(a), 98 Stat. 494, 873–74. Also, an unlimited estate tax exclusion is still available to the estates of decedents dying after 1982, provided that the decedent was receiving benefits on December 31, 1982, and irrevocably elected the form of benefit before 1983. DEFRA, Pub. L. No. 98-369, § 525(b)(3), 98 Stat. 494.

treatment, referred to as "qualified plans." Because the exemptions have limited value in an international estate planning context, the discussion is limited to one point. If the deceased employee contributed to such a qualified plan, that portion of the value of the payments attributable to the employee's contributions is included in his estate. This would include the value attributable to any contribution by the decedent's employer if it were made as a result of the decedent's employment.[144] The balance of the value of the payments from the qualified plan is excluded from the decedent's estate.

The value of an annuity or payment to a beneficiary who survives the decedent-employee must be included in the decedent's estate if it is made pursuant to an agreement under which it is payable to the decedent, or if the decedent possesses the right to receive it (alone or with another) for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before death.[145] For the purposes of sections 2039(a) and (b), "annuities" and "payments" refer to one or more payments, which may be equal or unequal, conditional or unconditional, periodic or sporadic.[146]

Section 2039 is inapplicable to agreements entered into "as insurance under policies on the life of the decedent." Amounts receivable under insurance policies on the life of the decedent are includible under section 2042 even though they may be received in annual payments rather than in a lump sum. The Treasury Regulations provide that section 2039 applies to a combination annuity contract and life insurance policy on the decedent's life (for example, a "retirement income" policy with death benefits) if there is no longer an insurance element present under the contract at the time of the decedent's death.[147]

In *Helvering v. Le Gierse*,[148] the Supreme Court concluded that "insurance involves risk-shifting and risk-distributing."[149] The Court held that the amounts payable were not "receivable as insurance"

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144. I.R.C. § 2039(b).
145. Treas. Reg. § 20.2039-1. This requirement is the same as that under I.R.C. § 2036.
146. Treas. Reg. § 20.2039-1(b)(1).
147. Treas. Reg. § 20.2039-1(d). However, a properly structured death benefit plan in which the employee has no lifetime benefits, but one which will provide survivor benefits to his widow or other dependents, should escape the reach of section 2039(a). Estate of Schelberg v. Comm'r, 612 F.2d 25 (2d Cir. 1979), *rev'g* 70 T.C. 690 (1978). The government has announced that it will follow the *Schelberg* decision in all circuits.
148. Helvering v. Le Gierse, 312 U.S. 531 (1941).
149. *Id.* at 539.

because the combination of the annuity and the insurance contract neutralized the risk inherent in an insurance policy.[150] "The total prepaid consideration exceeded the face value of the insurance policy" and any risk assumed by the insurer was an "investment risk," rather than an insurance risk.[151]

The insurance element of a contract "is generally determined by the relation of the reserve value of the policy to the value of the death benefit at the time of the decedent's death."[152] The "reserve value" is the total premiums that have been paid plus interest. If the value of the death benefit exceeds the reserve value, there is an insurance element present; if the reserve value equals or exceeds the death benefit, there is no longer an insurance element and the contract is subject to section 2039, rather than section 2042.

Section 2039 applies only to payments receivable by beneficiaries if they are provided for by the agreement. Thus, section 2039 is not applicable to a situation in which either the decedent-employee or the beneficiary has a mere expectancy of payments.[153]

Section 2039 also requires that the "annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment either alone or in conjunction with another."[154] The "was payable" requirement is satisfied "if, at the time of his death the decedent was in fact receiving an annuity or other payment, whether or not he had an enforceable right to have payments continued."[155] The "possessed the right to receive" requirement is satisfied "if, immediately before his death, the decedent had an enforceable right to receive payments at some time in the future, whether or not, at the time of his death, he had a present right to receive payments."[156] The decedent is deemed to have possessed such an enforceable right "so long as he had complied with his obligations under the contract or agreement up to the time of his death."[157] In

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150. *Id.*
151. *Id.* at 542. *See also* All v. McCobb, 321 F.2d 633 (2d Cir. 1963).
152. Treas. Reg. § 20.2039-1(d).
153. Estate of Barr v. Comm'r, 40 T.C. 227 (1963), *acq.*, 1964-2 C.B. 4, *and withdrawn in part, acq. in result in part*, 1978-2 C.B. 1 (the value of a "salary death benefit" and a "wage dividend death benefit" was not included in the gross estate because the decedent's employer retained complete discretion as to whether to make such payments and the decedent had no enforceable right to them). Annuities not includible under section 2039 may be included due to retention of other powers, such as a power to designate other beneficiaries.
154. I.R.C. § 2039(a).
155. Treas. Reg. § 20.2039-1(b)(1). *See* Estate of Wadewitz v. Comm'r, 39 T.C. 925 (1963), *aff'd*, 339 F.2d 980 (7th Cir. 1964).
156. Treas. Reg. § 20.2039-1(b)(1).
157. *Id.*

Estate of Wadewitz v. Commissioner,[158] the court emphasized that for section 2039 to be applicable, a right to future payments by the decedent must not be forfeitable except at the decedent's election.

The amount includible under section 2039 is "only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent."[159] This amount includes "any contribution by the decedent's employer or former employer to the purchase price of such contract or agreement (whether or not to an employee's trust or fund forming part of a pension, annuity, retirement, bonus or profit sharing plan). . . ."[160]

The value of the beneficiary's interest in the annuity at the decedent's death is determined in accordance with certain rules set forth in the Treasury Regulations.[161] The amount included in the decedent-employee's estate is found by multiplying the value of the annuity by a fraction, the numerator of which is the decedent-employee's contributions to the purchase price (including any employer contribution as a result of the employment relationship), and the denominator of which is the total purchase price.

Contributions made by an employer to a pension, stock, bonus, profit-sharing, or retirement plan that has qualified for exemption from income taxation or to an individual retirement arrangement, however, will not be included in such a determination. The phrase "by reason of his employment" is given a broad interpretation.[162]

[B] Section 2042

§ 2042. Proceeds of life insurance
The value of the gross estate shall include the value of all property—

(1) **Receivable by the executor.—**To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

(2) **Receivable by other beneficiaries.—**To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the

158. Estate of Wadewitz v. Comm'r, 39 T.C. 925 (1963), *aff'd*, 339 F.2d 980 (7th Cir. 1964).
159. I.R.C. § 2039(b).
160. *Id.* (stating that such contribution "shall be considered to be contributed by the decedent if made by reason of his employment").
161. Treas. Reg. § 20.2039-1(c).
162. *Id.*; S. REP. NO. 83-1622, at 471 (1954).

> incidents of ownership, exercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term "reversionary interest" includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

The Code does not define the term "insurance." However, the following policies are considered "insurance": conventional policies, either individual or group;[163] accident and flight insurance policies, to the extent they are paid upon the death of the insured;[164] War Risk and National Service Life Insurance policies;[165] and death benefits paid by fraternal beneficial societies operating under the lodge system.[166] In addition, an essential element of a life insurance contract is that the risk that the insured will not live for a certain period of time is shifted to the insurer. To the extent that the insurer will suffer a loss if the insured dies within the period, the contract is an insurance contract and subject to the provisions of section 2042.

Death benefits payable pursuant to liability insurance carried by a common carrier or industrial concern are not includible in the gross estate under section 2042 because such payments are contingent upon either a finding of legal liability or the compromise of a liability claim. Only if such a policy provides that the insurer pay the death benefits upon proof of accidental death are such proceeds includible.[167]

Section 2042 applies only to insurance policies on the life of the decedent. If the decedent owns an insurance policy on the life of another and predeceases the insured, the value of the policy at the time

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163. *See* Old Colony Trust Co. v. Comm'r, 39 B.T.A. 871 (1939).
164. *See* Comm'r v. Estate of Noel, 380 U.S. 678 (1965).
165. *See* U.S. Trust Co. v. Helvering, 307 U.S. 57 (1939).
166. Treas. Reg. § 20.2042-1(a)(1).
167. Rev. Rul. 57-54, 1957-1 C.B. 298.

of the owner's death is generally includible in the owner's estate under section 2033,[168] not section 2042.

The general rule of section 2042 is that proceeds of insurance policies on a decedent-insured's life are includible in his gross estate if they are receivable by his executor or any other beneficiary and, if the decedent had, at his death, any incident of ownership in the policy. It is not necessary that the estate or the executor be specifically named as the beneficiary of the policy. Under the regulations, if "the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate,"[169] the proceeds, to the extent of the obligations, are includible in the insured's estate. Insurance proceeds payable to a creditor of the insured as security for a loan to the insured would similarly be "receivable by the executor," presumably up to the amount of the loan.[170] As section 2042(1) provides that insurance proceeds "receivable by the executor" are includible in the gross estate, it is immaterial if another person takes out the policy and names the decedent insured's estate as beneficiary.

In certain community property states, if community property funds are used to pay premiums on an insurance policy, the decedent-insured's spouse is entitled to one-half the proceeds made payable to the insured's estate. Therefore, if an insured's spouse survives, only one-half of the proceeds in such states is considered as "receivable by or for the benefit of the decedent's estate."[171] Similarly, under certain state statutes, the surviving spouse and children are entitled to the proceeds of a life insurance policy on the decedent-insured's life that does not provide payment to other beneficiaries. In such states, the insurance proceeds, though nominally receivable by the estate, are treated as proceeds payable to other beneficiaries under section 2042(2).[172]

Section 2042(2) provides that the proceeds of life insurance policies on the life of a decedent-insured that are receivable by beneficiaries other than the decedent's estate are includible in his gross estate if, at his death, the decedent possesses "any of the incidents of ownership, exercisable either alone or in conjunction with any other person." The statute provides only one nonexclusive definition of an incident of

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168. Estate of Du Pont v. Comm'r, 18 T.C. 1134 (1952), *aff'd*, 233 F.2d 210 (3d Cir.), *cert. denied*, 352 U.S. 878 (1956).
169. Treas. Reg. § 20.2042-1(b).
170. *See* Prichard v. United States, 255 F. Supp. 552 (N.D. Tex. 1966), *aff'd*, 397 F.2d 60 (5th Cir. 1968).
171. Treas. Reg. § 20.2042-1(b)(2); *see* Estate of Carroll v. Comm'r, 29 B.T.A. 11 (1933). *See also* the discussion of community interests in life insurance in chapter 4, *infra*.
172. Estate of Nyemaster v. Comm'r, 2 T.C.M. 1183 (1943).

ownership—a reversionary interest, regardless of how it arises, exceeding 5% of the value of the policy immediately before the death of the decedent. The concept of "reversionary interest" as contained in this section is similar to that contained in section 2037. The value of such an interest is determined in the same manner as under section 2037.[173]

Although the statute gives no further definition of an "incident of ownership," section 20.2042-1(c)(2) of the Treasury Regulations does offer a definition:

> Thus, [the term "incidents of ownership"] includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.

The courts have specifically adopted this definition.[174] In *Commissioner v. Treganowan*,[175] the court held that the decedent possessed an incident of ownership in a nonconvertible insurance policy because, as a member of the New York Stock Exchange, he had the power to sell his membership, which would effectuate the cancellation of his policy.

Subsequently, however, the IRS ruled that when an employee had no privilege to convert a group-term policy to an individual policy, the power to cancel such a policy by terminating his employment would not be considered an incident of ownership.[176] Therefore, if the employee makes an irrevocable assignment of a group-term policy, the proceeds should not be includible in his gross estate under section 2042(2) even though by terminating his employment he might cause the cancellation of the policy as to him.[177]

The term "incidents of ownership" is not limited in its meaning to ownership of the insurance policy, but refers also to the right of the insured or his estate to the economic benefits of the policy.[178] If a

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173. Treas. Reg. § 20.2042-1(c)(3). *See also* Treas. Reg. § 20.2037-1(c)(3), (4).
174. *See* Comm'r v. Treganowan, 183 F.2d 288 (2d Cir.), *cert. denied sub nom.* Strauss's Estate v. Comm'r, 340 U.S. 853 (1950).
175. *Id.*
176. Rev. Rul. 72-307, 1972-1 C.B. 307; Rev. Rul. 84-130, 1984-2 C.B. 194.
177. *See also* Rev. Rul. 69-54, 1969-1 C.B. 221, *modified*, Rev. Rul. 72-307, 1972-1 C.B. 307; Rev. Rul. 84-130, 1984-2 C.B. 194 (a conversion privilege exercisable only in the event of the termination of employment is not an incident of ownership for purposes of § 2042(2)).
178. Mere economic benefits and the right to economic benefits were distinguished in Estate of Glade v. Comm'r, 37 T.C.M. 1318 (1978). In that case, life insurance policies on the decedent's life were issued to his children as owners and beneficiaries, and the decedent provided the funds for the policy premiums. Although he had no rights with regard to the policies, the decedent did benefit from them as the children assigned

decedent retains any right in or with respect to a policy on his life, the proceeds are includible in his estate regardless of how the policy is acquired or who pays the premiums. For example, in Revenue Ruling 79-46,[179] the IRS determined that the contractual right of an employee-decedent to prevent cancellation of an insurance policy on his life by purchasing the policy from the employer-owner for the policy's cash surrender value was of economic value to the decedent. The service equated the existence of the power to veto the exercise of any of the incidents of ownership with their affirmative exercise. However, at least one Tax Court case reached a contrary decision on virtually identical facts.[180] In addition, *Commissioner v. Estate of Noel* illustrates that the mere existence of an economic right is sufficient to cause the proceeds to be includible in the insured's estate.[181] The court

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the policies as security for a loan to the decedent's business and, at the decedent's death, a portion of the proceeds was used to satisfy the balance of that loan. The court concluded that the decedent did not possess any of the incidents of ownership.

179. Rev. Rul. 79-46, 1979-1 C.B. 303.

180. *See* Estate of Smith v. Comm'r, 73 T.C. 307 (1979), *acq. in part*, 1981-2 C.B. 2, where the Tax Court dealt with a virtually identical case and concluded that Rev. Rul. 79-46, 1979-1 C.B. 303 erroneously expanded the reach of Treas. Reg. § 20.2042-1(c)(2). As all of the incidents of ownership enumerated in this regulation were held by the employee's company, whatever rights the decedent may have acquired under his employment contract regarding his right to prevent cancellation of the policy by purchasing it for its cash value "were contingent, dependent on an event which never occurred and over which [the decedent] had no control." *Smith*, 73 T.C. at 309. Therefore, the court held that the decedent's rights were not incidents of ownership. *See also* Estate of Smead v. Comm'r, 78 T.C. 43 (1982), *acq.*, 1984-2 C.B. 2, where the court found that the decedent-employee's right to convert an employer-paid group life insurance policy into an individual policy on his life only upon ending his employment was not an "incident of ownership," as he would have had to suffer costly economic consequences in order to exercise that privilege.

181. Comm'r v. Estate of Noel, 380 U.S. 678 (1965). A split over the meaning of "incidents of ownership" in the context of fiduciary powers had developed between the Service and the Fifth Circuit on the one hand, and between the Tax Court and the Second, Third, Sixth, and Eighth Circuits on the other. In Estate of Skifter v. Comm'r, 468 F.2d 699 (2d Cir. 1972), the decedent had assigned all interest in insurance policies on his life to his wife, who, by her will, placed the policies in trust with the decedent as trustee. Although the decedent had broad management powers in his fiduciary capacity, he could in no way exercise these powers to gain any economic benefit for himself. Thus, the policies were not included in the decedent's gross estate under I.R.C. § 2042(a). *See also* Hunter v. United States, 624 F.2d 833 (8th Cir. 1980); Estate of Connelly v. United States, 551 F.2d 545 (3d Cir. 1977); Estate of Fruehauf v. Comm'r, 427 F.2d 80 (6th Cir. 1970); Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975), *acq.*, 1977-2 C.B. 1.

On the other side of the controversy is the view that insurance policies are includible in the gross estate if the decedent, as trustee, can affect the

held that proceeds from a flight insurance policy were includible because the decedent retained the legal right to change the beneficiary of the policy even though, as a practical matter, he was unable to exercise the right while the plane was in flight. There is no clear consensus among the different judicial circuits on the meaning of "incidents of ownership." The issue is the subject of continued litigation.

In certain situations, a decedent's indirect ownership of a policy may result in the inclusion of the proceeds in his gross estate. For example, assume a decedent-insured is the sole or controlling stockholder of a corporation that owns insurance on his life. Further, assume that part of the policy's proceeds are not payable to the corporation and, therefore, are not taken into account in valuing the decedent's stock holdings in the corporation. The incidents of ownership held by the corporation as to the part of the insurance proceeds that are not paid to the corporation are attributed to the decedent through his stock ownership.[182]

Conversely, if all the economic benefits of the policy are reserved to the corporation, the corporation's incidents of ownership are not attributed to the decedent through his stock ownership. This is true even if a part of the proceeds is "payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by

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time and manner of enjoyment even though the decedent cannot himself enjoy their economic benefits. In Rev. Rul. 76-261, 1976-2 C.B. 276 (revoked; *see* discussion below), the decedent, as trustee, had the ability to borrow on the policy, to elect optional modes of settlement, and to withdraw dividends pursuant to the terms of the trust and the insurance policies. The Service announced that it would not follow the holding of *Skifter*, and concluded that such control was an incident of ownership. *See* Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); Rose v. United States, 511 F.2d 259 (5th Cir. 1975); Estate of Lumpkin v. Comm'r, 474 F.2d 1092 (5th Cir. 1973). However, Rev. Rul. 76-261 was revoked by Rev. Rul. 84-179, 1984-2 C.B. 195. The IRS changed its prior position that insurance policies are includible in the gross estate if the decedent, as trustee, can affect the time and manner of enjoyment even though the decedent himself cannot enjoy their economic benefit. The Service now has adopted a position consistent with that espoused by the several courts of appeal that a decedent will be deemed to have an incident of ownership in an insurance policy held on his life in trust only if his fiduciary powers over the policy were retained as grantor of the trust.

182. Treas. Reg. § 20.2042-1(c)(6) ("controlling stockholder" is defined as being one who owns stock possessing more than 50% of the total combined voting power of the corporation).

the amount of such proceeds."[183] The corporation's power to surrender or cancel a group-term life insurance policy held by it is not, however, attributed to a decedent through his stock ownership.[184]

As to group-term life insurance, the Service has ruled that the proceeds from such insurance are not includible in the decedent-employee's estate if

(1) he makes a lifetime assignment of all his incidents of ownership in the policy;
(2) both the policy and state law permit such an absolute assignment, including the conversion right; and
(3) the policy is funded entirely by the employer.[185]

The vast majority of states have since enacted statutes specifically permitting the assignment of group life insurance policies.

In general, if the statutory tests for inclusion are met, "the full amount receivable under the policy" is included in the gross estate.[186] If the proceeds are not payable in a lump sum, the amount includible is the amount payable in a lump sum under an option exercisable either by the beneficiary or the insurer. If no such option exists, the amount includible is the sum used by the insurance company in determining the amount of the annuity.[187] If the periodic payments are merely payments of interest on the proceeds and not an annuity, the face amount of the policy is included.[188] If a decedent irrevocably assigns his incidents of ownership to a beneficiary, but a portion of the proceeds is pledged as security for an obligation for which his estate is liable, that portion of the proceeds is includible in his estate as an amount "receivable by the executor."[189]

Whether or not the insurance proceeds are includible under section 2042, the proceeds or the premium payments may be includible under section 2035. The IRS should not attempt to include in the decedent's gross estate the proceeds of life insurance policies taken out and irrevocably transferred more than three years before death; only premium payments made by the decedent within that three-year

183. *Id.*
184. *Id.*
185. Rev. Rul. 69-54, 1969-1 C.B. 221, *modified by* Rev. Rul. 72-307, 1972-1 C.B. 307 *and* Rev. Rul. 84-130, 1984-2 C.B. 194.
186. Treas. Reg. § 20.2042-1(a)(3).
187. *Id.*
188. Estate of Willis v. Comm'r, 28 B.T.A. 152 (1933).
189. Treas. Reg. § 20.2042-1(b)(1); *see also* Estate of Matthews v. Comm'r, 3 T.C. 525 (1944).

period should be included.[190] If the transfer occurs within the three-year period, the proceeds would generally be includible.[191] The proceeds of a one-year accidental death policy (the premium of which is paid by the decedent) are fully includible in the gross estate even if the decedent makes an irrevocable transfer of the ownership of the policy to a beneficiary.[192]

Issues also arise under section 2035 when an employer changes group insurance carriers or when the coverage is increased. In Revenue Ruling 80-289,[193] however, the Service indicated that a later (within three years of death) assignment of a policy that was the object of an earlier (more than three years prior to death) anticipatory assignment, should not cause the proceeds to be included in the employee-insured's gross estate where the later assignment was necessitated by the change of the employer's master insurance carrier and the new arrangement was identical in all relevant respects to the previous arrangement.

[C] Summary

The Code provisions describing the property includible in the gross estate of a U.S. citizen or resident alien are all inclusive. Many transfers causing property to be included in a resident alien's estate may occur prior to the alien's attaining resident status. Excluding section 2035, if a nonresident alien transferor retains or otherwise possesses the requisite rights and powers over property at the time of his death as a U.S. citizen or resident alien, the value of such property is includible in his U.S. gross estate. The absence of case law in this area may be due to the fact that aliens' personal representatives are unaware of property transfers prior to the acquisition of U.S. residence.

§ 2:5 Deductions and Credits

§ 2:5.1 Deductions

The determination of the gross estate is the starting point for fixing the federal estate tax. Once the components of the gross estate are identified, it is appropriate to examine the deductions that apply to determine the value of the taxable estate.

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190. Rev. Rul. 71-497, 1971-2 C.B. 329, *revoking* Rev. Rul. 67-463, 1967-2 C.B. 327. The employer's premium payments are indirect transfers by the insured employee. Rev. Rul. 76-490, 1976-2 C.B. 300. *See also* Rev. Rul. 82-13, 1982-1 C.B. 132.
191. I.R.C. § 2035(c).
192. *See* Bel v. United States, 452 F.2d 683 (5th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972).
193. Rev. Rul. 80-289, 1980-2 C.B. 270.

The estate of a resident alien is allowed the same deductions as the estate of a U.S. citizen. Such deductions include state estate taxes paid; funeral and administration expenses and claims against the estate (including claims for certain taxes);[194] losses, casualties, or thefts occurring during estate administration;[195] charitable deductions;[196] and the marital deduction,[197] provided, however, in the case of the marital deduction that (i) the surviving spouse is a U.S. citizen, or (ii) property passes to the surviving spouse by means of a "qualified domestic trust,"[198] described below.

To alleviate some of the burden of multiple taxation, a state death tax deduction is allowed against the federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any state of the United States or to the District of Columbia.[199]

Funeral expenses are allowed as a deduction only if they are in fact paid by the personal representative of the decedent and the law of the relevant jurisdiction requires them to be paid.[200] Allowable funeral expenses include reasonable expenses for the funeral, transportation of the body, a burial plot, a monument, and perpetual care of the cemetery plot if allowed under local law.

Expenses for the administration of a decedent's estate, known as "administration expenses," are deductible. They include only those expenses necessary to the proper settlement of the estate, such as executors' commissions, attorneys' fees, and miscellaneous expenses such as court costs, surrogates' fees, accountants' fees, appraisers' fees, and the like.[201] Miscellaneous expenses also deductible include expenses necessarily incurred in preserving and distributing the decedent's property (including the cost of storing or maintaining it for a

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194. I.R.C. § 2053.
195. *Id.* § 2054.
196. *Id.* § 2055.
197. *Id.* § 2056.
198. *See id.* § 2056A.
199. I.R.C. § 2058. To avoid a significant revenue loss which likely would have resulted from the phaseout and elimination of the state death tax credit, many states and the District of Columbia have either enacted legislation imposing a state estate tax or "decoupled" from the changes made by the Tax Act of 2001 and tying their respective state estate taxes to the federal estate tax law in effect prior to the Tax Act of 2001. Several states have enacted an inheritance tax, in addition to, or in place of, an estate tax.
200. Treas. Reg. § 20.2053-2. For example, if the law of any state of the United States provides that the funeral expenses for a wife are the obligation of the husband unless there is a specific provision authorizing and directing the payment of such expenses in the wife's will, they are not payable out of her estate and, therefore, not deductible.
201. *See* Treas. Reg. § 20.2053-3(a)–(d)(1).

reasonable period of time if immediate distribution is impossible) or in selling the decedent's property (including brokerage fees) if the sale is necessary to pay the decedent's debts, expenses of administration, or taxes; to preserve the estate; or to effect distribution.[202]

Enforceable claims against the decedent's estate are deductible only if they represent personal obligations of the decedent existing at his death, including interest accrued at that time.[203] Such claims include enforceable charitable pledges or subscriptions to the extent they would be allowable under section 2055 if they were bequests; alimony; personal contractual obligations; claims arising out of torts; taxes, such as unpaid income taxes, property taxes, gift taxes, and excise taxes; mortgages, provided the mortgaged property is reported at its full value; expenses for administering property not subject to claims (for instance, for the collection of certain assets that may not be includible in the probate estate); and certain state and foreign death taxes imposed on property transferred by the decedent for public, charitable, or religious uses (as described in section 2055) to the extent that the resulting decrease in tax inures to the benefit of the public or charitable transferee.[204]

Losses incurred during the administration of an estate arising from fires, storms, shipwrecks, or other casualties, or from theft, are deductible to the extent they are not compensated for by insurance.[205]

Many expenses of administration and losses that qualify as estate tax deductions also qualify as income tax deductions for the estate. Generally, these deductions are not allowed for both estate and income tax purposes, but this rule does not apply to deductions for taxes, interest, business expenses, and certain other items accrued at the date of the decedent's death.[206] If the estate desires to take a deduction for income tax purposes for an expense not accrued at decedent's death, the estate must file a waiver of its rights to claim it as an estate tax deduction.[207]

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202. Treas. Reg. § 20.2053-3(d)(2).
203. Treas. Reg. § 20.2053-4.
204. *See* Treas. Reg. § 20.2053-5 to -6; § 20.2053-7; § 20.2053-8; § 20.2053-9; § 20.2053-10. With regard to the deduction for certain foreign death taxes imposed on property passing to organizations described in § 2055, if it is claimed, there would have to be an appropriate adjustment to the credit for foreign death taxes.
205. I.R.C. § 2054; Treas. Reg. § 20.2054-1.
206. I.R.C. §§ 2053(a)(3), 691(b).
207. *Id.* § 642(g). This requirement was extended to postmortem selling expenses after October 4, 1976, by the 1976 Act.

Bequests, legacies, devises, or transfers to certain U.S. governmental entities, or to corporations or associations organized and operated exclusively for religious, charitable, scientific, literary, educational, or certain public purposes are deductible.[208] The deduction is not limited to domestic corporations or associations, nor do any percentage limitations apply as in the income tax area.[209] The benefit of the transfer cannot inure to an individual for noncharitable purposes, and a corporation or association will not qualify for the charitable deduction if a substantial part of its activities is to influence legislation or if it participates or intervenes in a political campaign on behalf of (or in opposition to) a candidate. The deduction is for the value of the transferred property only, provided it is included in the decedent's gross estate. If the property is subject to death taxes (federal or state) or if it bears a share of the administration expenses, then only the net amount is deductible.

If a decedent has a general testamentary power of appointment that would cause the property to be included in his estate under section 2041, and if he exercises it, releases it, or allows it to lapse in favor of a qualified charity, his estate will obtain the charitable deduction.

The extraordinarily technical rules pertaining to charitable remainder trusts (charitable remainder annuity trusts or charitable remainder unitrusts)[210] will not be discussed here due to their narrow application. It should be noted that a charitable deduction is available only if it is certain that the qualified charity will receive the property; thus conditional transfers do not qualify.

The Code permits an unlimited amount of property (except for certain terminable interests) to be transferred between spouses free of estate or gift taxes.[211] Generally, the property qualifying for the marital deduction must be includible in the estate of the decedent and must pass to the surviving spouse in such a manner that it will be includible in the surviving spouse's estate unless it is previously transferred or consumed or the surviving spouse is not subject to the federal estate tax.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) affected the allowance of the marital deduction to the estates of persons who are married to non-U.S. citizens. Under Code section 2056(d), the marital deduction is not allowed for the value of property passing to a non-U.S. citizen spouse (whether or not a U.S. resident),

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208. I.R.C. § 2055.
209. Treas. Reg. § 20.2055-1(a).
210. I.R.C. § 664.
211. I.R.C. § 2056.

unless such property passes by means of a "qualified domestic trust," or "QDOT."[212] As a result of the amendments made by the Omnibus Budget Reconciliation Act of 1989, the marital deduction is also allowed for property passing to a noncitizen spouse if the spouse becomes a U.S. citizen prior to the date the estate tax return of the decedent is filed, provided that the noncitizen spouse was a U.S. resident on the date of the decedent's death and at all times thereafter before becoming a U.S. citizen.[213] All property passing from a decedent to a non-U.S. citizen spouse under a will or outside the probate estate is treated as passing in a QDOT if such property is transferred or irrevocably assigned to such a trust before the estate tax return is made.[214] Common examples of property passing outside a probate estate are property held by spouses in joint name with the right of survivorship, proceeds from life insurance policies, or benefits from pension or profit-sharing plans. A QDOT may be created by the decedent, or the decedent's executor or surviving spouse after the decedent's death.

In order for a trust to be a QDOT, the following requirements must be met:

1. except as provided in Treasury Regulations, the trust must require that at least one trustee be an individual U.S. citizen or U.S. corporation;[215]
2. the trust instrument must provide the U.S. trustee with the right to withhold the estate tax imposed on any principal distribution from the trust;[216]
3. the trust must comply with such regulations as are promulgated to ensure the collection of any estate tax imposed on the trust;[217] and

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212. *Id.* § 2056(d)(2). Property passing from a non-U.S. resident non-U.S. citizen to a non-U.S. citizen surviving spouse will also qualify for the estate tax marital deduction if it passes by means of a QDOT, according to the House Report that accompanies the Omnibus Budget Reconciliation Act of 1989, H.R. REP. NO. 101-247, at 1431 (1989–90), *reprinted in* 1989 U.S.C.C.A.N. 2372, 2901.
213. I.R.C. § 2056(d)(4).
214. *Id.* § 2056(d)(2)(B). The statutory language uses the word "made," which presumably would allow for a transfer of property during the period for which an extension to file the estate tax return was granted. *See* Treas. Reg. §§ 20.2056A-2(b)(2) and -3(a).
215. *Id.* § 2056A(a)(1)(A).
216. *Id.* § 2056A(a)(1)(B).
217. *Id.* § 2056A(a)(2). The secretary of the treasury issued Treasury Regulations on November 27, 1996, pertaining to the collection of the estate tax for qualified domestic trusts under I.R.C. § 2056A, which included

4. the executor of the decedent must make an irrevocable election with respect to the trust.[218]

Although Code section 2056A(a) does not require the non-U.S. citizen surviving spouse to have an income interest in a QDOT, such an interest is required in order to satisfy the terminable interest rules under sections 2056(b)(5) and 2056(b)(7).[219] If a trust does not meet the requirements for a QDOT, as stated above, but would have qualified for the marital deduction in all other respects, the time for determining whether a trust will qualify as a QDOT may be extended if a reformation proceeding is commenced prior to the due date for filing the estate tax return. In that event, the determination of whether the trust qualifies as a QDOT will be made at the conclusion of the reformation proceeding.

The purpose of the requirement set forth in the above subparagraph 3 is generally to ensure that an estate tax (the "deferred estate tax") is paid at the earlier of the following occurrences: (a) upon a distribution of trust principal before the surviving spouse's death (except in the case of hardship), in which case the deferred estate tax would apply to the value of the principal distributed, or (b) upon the death of the surviving spouse,

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changes to the rules on personal residences and trust security arrangements. Treas. Reg. § 20.2056A-2(d). In addition, the IRS issued Rev. Proc. 96-54, 1996-2 C.B. 386, which is intended to assist practitioners in implementing some of the changes.

218. The election to treat a trust as a QDOT must be made on the estate tax return, in accordance with I.R.C. § 2056A(d).

219. Terminable interests passing to the surviving spouse generally do not qualify for the marital deduction. An interest is terminable if it terminates or fails due to the passing of time, the occurrence of an event or contingency, or the failure of an event or contingency to occur. Prior to ERTA, the key exception to the terminable interest rule was a life estate coupled with a general power of appointment in the surviving spouse, which qualified for the marital deduction.

Since ERTA, if certain conditions are met, a life estate in the surviving spouse (without a general power of appointment) will result in both the life and remainder interests qualifying for the marital deduction if the personal representatives of the decedent's estate so elect; this is known as qualified terminable interest property. I.R.C. § 2056(b)(7).

In addition, ERTA provided that both the life and remainder interests will qualify for the marital deduction (without election) if the surviving spouse is left a life estate and the remainder is payable to a qualified charity, assuming certain conditions involving charitable remainder trusts are satisfied. ERTA also removed the provisions of prior law that excluded community property from the adjusted gross estate for purposes of determining the maximum available marital deduction. ERTA, Pub. L. No. 97-34, § 403(a)(1)(A), 95 Stat. 172. Thus, such transfers qualify for an estate tax marital deduction for estates of decedents dying after 1981. Of course, where a non-U.S. citizen surviving spouse is involved, the requirements for a QDOT also must be met.

in which case the deferred estate tax would apply to the value of the principal remaining in the trust as of the surviving spouse's death.[220] The imposition of the deferred estate tax would be accelerated, however, if there were no U.S. citizen or domestic corporation acting as a trustee of the trust or if the trust were to cease to meet the regulatory requirements to ensure the payment of tax.[221] If the trust were thus disqualified, the estate tax would apply to the value of all the principal remaining in the trust at that time.

In the most simple terms, the amount of the deferred estate tax imposed would be the additional estate tax that would have been due had the value of the principal of the trust subject to the deferred estate tax (either because of distribution of principal to, or the death of, the surviving spouse) been included in the decedent spouse's estate.[222] The deferred estate tax imposed on a QDOT would be treated as an estate tax paid with respect to the decedent's estate.[223]

To the extent that the estate tax (deferred or not) is imposed with respect to property because

(a) of a distribution of principal to the surviving spouse,
(b) of the death of the surviving spouse, or
(c) a QDOT is not utilized,

a credit generally will be allowed against any estate tax imposed on the surviving spouse's estate with respect to that property.[224]

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220. I.R.C. § 2056A(b)(1)(A), (B).
221. *Id.* § 2056A(b)(4). Any occurrence resulting in the imposition of estate tax on a QDOT is defined in the legislation as a "taxable event." *Id.* § 2056A(b)(9).
222. Technically, this is accomplished by imposing an estate tax equal to the excess of (a) the estate tax that would have been imposed on the decedent's estate if the estate had been increased ("grossed-up") by the aggregate amount involved in the taxable event (*i.e.*, the principal distributed) plus all previous taxable events, over (b) the tax that would have been imposed if the estate had been increased only by the aggregate amount of any previous taxable events. *Id.* § 2056A(b)(2).
223. It is unclear whether the credit is allowed for estate tax imposed on trust property as a result of the disqualification of a trust pursuant to I.R.C. § 2056A(b)(4). As a policy matter, such credit should remain available.
224. I.R.C. § 2056(d)(3) provides that this credit for tax on prior transfers is to be determined without regard to when the first decedent dies, so that it appears that the credit will be 100% of the amount of estate tax imposed with respect to such property. This is a departure from the general rule of I.R.C. § 2013, which provides for the reduction of the credit in stages depending upon the length of time the surviving spouse survives, eliminating the credit entirely if the surviving spouse survives the first decedent by more than ten years.

Further, in the event the estate tax imposed on the estate of the deceased spouse has not been determined prior to (a) a distribution of principal from a QDOT to the surviving spouse or (b) the death of the surviving spouse who has an interest in a QDOT, the rate of the applicable estate tax at either of the aforesaid events will be the highest rate of estate tax in effect on the date of the decedent's death.[225] There is a provision for a credit or refund once the tax is finally determined.[226]

All trust distributions of income to the non-U.S. citizen surviving spouse are exempt from the estate tax. In addition, estate tax-free distributions of principal are permitted in the case of hardship.[227] A QDOT or a QDOT beneficiary also may be subject to the generation-skipping transfer tax, where applicable.[228]

As mentioned above, in order to qualify as a QDOT, a trust must, among other requirements, satisfy regulatory requirements promulgated by the Secretary of the Treasury (the QDOT Regulations) relating to the QDOT provisions of the Code. This discussion highlights many important aspects of the QDOT Regulations. For the purpose of this discussion, assume the decedent's surviving spouse is not a citizen of the United States.

First, the QDOT Regulations clarify that the Code imposes a deferred estate tax upon the occurrence of the following taxable events: upon distributions from the trust to the surviving spouse during the lifetime of the surviving spouse, upon the death of the surviving spouse, or upon the trust's ceasing to qualify as a QDOT.[229] If the applicable taxable event is the death of the surviving spouse or the trust's ceasing to qualify as a QDOT, the value of the trust corpus is subject to the deferred estate tax. Regarding lifetime distributions to the surviving spouse, all distributions other than distributions of income from the trust assets (but not including capital gains) and distributions of principal on account of hardship are subject to the deferred estate tax.

A distribution is made on account of hardship only if made to the surviving spouse in response to an immediate and substantial financial need relating to the spouse's health, maintenance, or support, or the health, maintenance, education, or support of any person that the

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225. *Id.* § 2056A(b)(2)(B)(i).
226. *Id.* § 2056A(b)(2)(B)(ii). A claim for credit or refund of overpayment must be filed within one year of the final determination.
227. *Id.* § 2056A(b)(3)(B). As discussed below in the text, the regulations clarify the meaning of a "distribution of principal on account of hardship."
228. *See* discussion in section 2:7, *infra.*
229. Treas. Reg. § 20.2056A-5(a), (b).

surviving spouse is legally obligated to support.[230] A distribution will not be considered to be made on account of hardship if the spouse has other sources of funds reasonably available.[231]

Generally, the deferred estate tax is computed using the estate tax rate applicable to the first decedent.[232] In the case of lifetime distributions or in the case of a trust ceasing to qualify as a QDOT, the tax is payable on the fifteenth day of April following the calendar year in which the lifetime distribution occurs; in the case of a distribution upon the death of the surviving spouse, the tax is due nine months after the date of death of the surviving spouse.[233] To the extent the surviving spouse's estate is subject to U.S. estate tax, any deferred estate tax described above will be treated as paid by the estate of the first decedent and, subject to limitations, will be creditable against the surviving spouse's U.S. estate tax liability.[234]

Second, the QDOT Regulations provide that a trustee may make a protective QDOT election, but only if, at the time the U.S. federal estate tax return is filed, there is a bona fide controversy relating to either the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether an asset is includible in the decedent's gross estate or the amount or nature of the property the surviving spouse is entitled to receive.[235] Although no partial election may be made, if a trust is severed in accordance with the regulation, an election may be made for any one or more of the severed trusts.[236]

Third, the QDOT Regulations clarify that if a surviving spouse transfers or irrevocably assigns property to a QDOT, such property is treated as passing from the decedent to the surviving spouse solely for the purposes of qualifying for the marital deduction. For all other purposes (that is, income, gift, estate, generation-skipping transfer, and certain excise taxes), the surviving spouse is treated as the transferor of the property to the QDOT, unless the transfer by the surviving spouse constitute a transfer that satisfies the requirements of section 2518(c)(3).[237]

Fourth, the QDOT Regulations provide that an annuity payable to the surviving spouse will meet the QDOT requirements if the surviving spouse either (i) annually pays deferred estate tax on the "corpus portion" of each annuity payment received or (ii) agrees to transfer or

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230. Treas. Reg. § 20.2056A-5(c).
231. *Id.*
232. Treas. Reg. § 20.2056A-6.
233. 26 U.S.C. § 2056A(b)(5). However, an extension of not more than six months may be obtained. Treas. Reg. § 20.2056A-11(a), (b).
234. Treas. Reg. § 20.2056A-7.
235. Treas. Reg. § 20.2056A-3(c).
236. Treas. Reg. § 20.2056A-3(b).
237. Treas. Reg. § 20.2056A-4(b)(5).

"roll over" the corpus portion of each annuity payment to a QDOT within sixty days of the receipt.[238]

Fifth, if more than one QDOT is established with respect to a decedent, the decedent's estate tax return or the first Form 706QDT that is due must designate a person (the Designated Filer) responsible for filing deferred estate tax returns required under Code section 2056A(b)(2)(C)(i).[239] The Designated Filer must be a U.S. Trustee, and, if an individual, must have a home (as defined in Code section 911(d)(3)) in the United States.

Sixth, for the purposes of determining increased basis only, a distribution of property from a QDOT to a surviving spouse is treated as a transfer by gift. Any tax paid on the distribution is treated as gift tax paid, and thus the surviving spouse's basis on the property acquired in the distribution from the QDOT will be increased by some portion of the tax paid.[240]

In addition, to ensure that there are sufficient assets to pay the U.S. estate tax when a deferred payment is due and to ensure the collectibility of that deferred estate tax, on November 27, 1996, the Secretary of the Treasury issued final regulations to ensure the collection of the estate tax for QDOTs.[241] In addition, the IRS issued Revenue Procedure 96-54[242] to assist practitioners in implementing these rules. If the fair market value of the assets of the QDOT at the time of the death of the first decedent exceeds $2 million (exclusive of real property, used by the surviving spouse as a principal residence and related personal effects, other than rare artwork, valuable antiques or automobiles, in an amount not to exceed $600,000), a QDOT may alternate among three different arrangements as security that the estate tax will be paid as long as at least one of the three is in effect at all times. The three arrangements are:

(i) at least one trustee of the QDOT must be a "bank" as defined in Code section 581;

(ii) the trustee must furnish a bond to the IRS in the amount of 65% of the fair market value of the QDOT assets; or

(iii) a letter of credit to the IRS in the amount of 65% of the fair market value of the QDOT assets.[243]

If, however, the value of the assets of the QDOT does not exceed $2 million as of the date of the death of the decedent, the regulations

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238. Treas. Reg. § 20.2056A-4(c).
239. Treas. Reg. § 20.2056A-9.
240. *See* Treas. Reg. § 1.1015-5(c)(4).
241. Treas. Reg. § 20.2056A-2(d).
242. Rev. Proc. 96-54, 1996-2 C.B. 386.
243. *Id. See* discussion in section 2:4, *supra.*

require that either (i) the QDOT must satisfy one of the three requirements described above, or (ii) the trust instrument must expressly provide that no more than 35% of the trust's assets, determined on an annual basis, may be invested in real property located outside the United States.[244] Moreover, the requirements set forth in the regulations are governing instrument requirements; not only must they be met in fact, but the instrument governing the QDOT must include these requirements or they may be incorporated by reference, rather than including detailed provisions within the document itself. Revenue Procedure 96-54 provides assistance to individuals who do want to specify the required provisions in their trusts' governing instruments. The revenue procedure contains sample language that can be used in such an instrument to satisfy the security requirements. In addition, the QDOT regulations contain an anti-abuse rule that provides for the disqualification of a QDOT in the event the trust uses any device or arrangement that has, as a principal purpose, the avoidance of liability for the deferred estate tax or for the prevention of the collection of the tax.[245]

In determining whether a trust's assets exceed $2 million and whether the bond or letter of credit securing the trust's taxes is actually equal to 65% of the fair market value of the trust's assets, indebtedness is not taken into account. Up to two residences for the surviving spouse are excluded. The provision, however, is available for the surviving spouse's principal residence and one additional residence, as long as:

(i) the combined value excluded does not exceed $600,000,
(ii) the second residence is used by the surviving spouse as a personal residence, and
(iii) the second residence is not subject to any rental arrangement.[246]

The residence exclusion is made by attaching a written statement to the estate tax return on which the QDOT election is made. The election can be made at any time during the term of the QDOT. The rules

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244. Treas. Reg. § 20.2056A-2(d)(1)(ii).
245. Treas. Reg. § 20.2056A-2(d)(1)(iv). The 35% limitation on ownership of foreign real property includes not only real property owned directly by the QDOT, but is subject to certain "look through" rules when the property is owned by an entity consisting of fifteen or fewer shareholders or partners and 20% of which is owned directly or, through attribution rules, indirectly by the QDOT.
246. Treas. Reg. § 20.2056A-2(d)(1)(iv).

require that if a residence subject to the exclusion is sold, or if it ceases to be used as a personal residence, the trustee must notify the IRS.

§ 2:5.2 *Credits*

The tax credits available to the estate of a resident alien are the credit for the applicable exclusion amount, the gift tax credit for gifts made prior to 1977, the credit for tax on prior transfers, and the credit for foreign death taxes.

[A] Applicable Exclusion Amount

Under current law, the applicable exemption amount is $5,000,000 (this amount is indexed for inflation and is $5,340,000 in 2014).[246.1]

The applicable exemption is first used to offset any gift taxes payable on inter vivos transfers; to the extent so used, the credit available for estate tax purposes is reduced. If, however, the decedent made a taxable inter vivos transfer before 1977 and the transferred property is includible in his gross estate, an additional credit is allowed for the gift tax paid on the transfer.

[B] Gift Tax Credit

If a decedent made a taxable gift prior to 1977 and the property is included in his estate, his estate is entitled to a credit for the gift tax paid.[247] This eliminates potential double taxation. The credit is limited, however, to the *lesser* of two amounts, referred to as "limitations."

The first limitation is the amount of the gift tax paid on the gift.[248] If more than one taxable gift was made during the relevant period, only the proportion of the gift tax attributable to the gift that was includible in the estate is allowed. In determining this proportion, appropriate adjustments must be made for the annual exclusion, and any applicable charitable and marital deductions claimed as deductions for the gift tax paid. It is stated algebraically as follows:

Total taxable gifts plus specific exemption allowed	×	Total gift tax paid amount	=	Value of gift, less any portion excluded (by the annual exclusion) or deducted (as a charitable or marital deduction)

246.1. I.R.C. § 2010; Rev. Proc. 2013-35, 2013-2 C.B. 537.
247. I.R.C. § 2012(a).
248. *See* Treas. Reg. § 20.2012-1(c).

The second limitation is the amount of the estate tax attributable to the inclusion of the gift in the decedent's gross estate.[249] This amount is the proportion of the estate tax attributable to the gift, less the credit for state death taxes (for estates of decedents dying before December 31, 2004). In setting up the formula to calculate the proportion, the value of the gift is the lesser of the value used for gift or estate tax purposes, as appropriately adjusted for the annual exclusion and the marital and charitable deductions, if any, and the value of the estate is the value of the decedent's entire gross estate (as reduced by the applicable charitable and marital deductions). It is stated algebraically as follows:

$$\text{Amount} = \frac{\text{Value of gift}}{\text{Value of gross estate, less marital and charitable deductions}} \times \begin{array}{c}\text{Gross estate tax,}\\ \text{less}\\ \text{Any credit for state death taxes}\end{array}$$

[C] Credit for Tax on Prior Transfers

Credit for tax on prior transfers is allowed against the estate tax for all or part of the estate tax paid with respect to the transfer of property to the decedent by or from a person who died within ten years before or within two years after the decedent.[250] The purpose is to provide some relief where there are successive taxes on the same property during a short period of time.

This credit is also restricted to the lesser of two limitations. The first limitation is the amount of the estate tax on the transferor's estate attributable to the property transferred. This amount is the proportion of the transferor's federal[251] estate tax attributable to property subject to the prior transfer tax, adjusted by adding any credits for gift taxes and prior transfers that were taxed.

In setting up the formula to calculate the proportion, the value of the transferor's taxable estate is adjusted by subtracting the sum of the decedent's death taxes (federal, state, and foreign) and adding any exemption allowed.[252] This is stated algebraically as follows:

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249. *See* Treas. Reg. § 20.2012-1(d).
250. I.R.C. § 2013(a).
251. Treas. Reg. § 20.2013-1(b)(1).
252. Treas. Reg. § 20.2013-2.

$$\text{Amount} = \frac{\text{Value of transferred property}}{\text{Transferor's adjusted taxable estate}} \times \begin{array}{c}\text{Transferor's adjusted federal estate tax for property subject to prior transfer tax} \\ + \\ \text{credit for gift taxes and prior transfers}\end{array}$$

The second limitation is the amount of the federal estate tax (after subtracting the applicable exclusion amount credit and any other credits) on the transferee's property attributable to the transferred property.[253] This is calculated by computing the federal estate tax on the transferee's estate (after subtracting any credits), first including the value of the transferred property and then excluding the value of the transferred property and subtracting the result of the second calculation from the result of the first.[254]

If the transferor died more than two years before the transferee, the lesser of the two limitations is reduced by 20% for each full two-year period by which the transferor predeceased the transferee. Consequently, if the transferor predeceased the transferee by ten years, no credit is available. The value of the property used for the above calculations is the value of the property in the estate of the transferor as adjusted by certain amounts set forth in the statute.[255]

[D] Credit for Foreign Death Taxes

Section 2014 provides for a foreign death tax credit, as do the estate tax treaties in which the United States is a party. If there is no treaty, the estate is limited to the credit under section 2014; if there is a treaty, the decedent's estate may elect whichever credit is most favorable.[256] If more than two jurisdictions are involved and two or more foreign death tax credits are allowed under section 2014 or under section 2014 and a treaty, the aggregate amount is credited.[257] If two countries tax the same property, however, the aggregate amount of the credits with regard to that property is limited to the amount of

253. Treas. Reg. § 20.2013-1(b)(2).
254. Treas. Reg. § 20.2013-3.
255. I.R.C. § 2013(d).
256. Treas. Reg. § 20.2014-4(a). The interrelationship of the foreign death tax credit and the credit for tax on prior transfers requires a careful calculation under the applicable treaty and under the Code before a final decision is made to use one or the other. *See* Treas. Reg. § 20.2014-4(a)(2).
257. Treas. Reg. § 20.2014-1(a)(2).

the federal estate tax attributable to it pursuant to the application of the second limitation, described hereinafter.[258]

Under section 2014, the foreign tax credit is allowed for any estate, inheritance, legacy, or succession taxes actually paid with respect to property situated (under U.S. situs rules) in a foreign country and included in a decedent's estate for federal estate tax purposes. Such situs is attributable to a political subdivision of a country if the subdivision imposes a tax even though the property is not situated in the subdivision but is situated in the country. If a foreign country imposes a death tax on property situated (under U.S. rules) in another country, however, no credit is available.[259]

Like the gift tax credit and credit for tax on prior transfers, the foreign death tax credit is restricted to the lesser of two limitations. The first limitation is the amount of the foreign death tax, without any allowance of a credit for the federal (U.S.) estate tax, attributable to the property included in the decedent's gross estate.[260] It is stated algebraically as follows:

$$\text{Amount} = \frac{\text{Value of property situated in and taxed by foreign country and included in decedent's federal estate [note: no administration deductions for foreign taxes are applicable]}}{\text{Value of all property subject to foreign death tax}}[261] \times \text{Amount of the foreign death tax}$$

The value of the property is that used by the foreign country to calculate the foreign death tax (converted into U.S. currency) even though a different value may be used for federal estate tax purposes. If a foreign country applies different death taxes or rates to different shares or assets of the estate, the first limitation is calculated as to each and then added.[262]

The second limitation is the amount of the federal estate tax, as reduced by the applicable exclusion amount credit and any state (for estates of decedents dying before December 31, 2004) and gift tax

258. Treas. Reg. § 20.2014-4(c).
259. See chapter 3 for discussion of the situs rules.
260. I.R.C. § 2014(b)(1).
261. Treas. Reg. § 20.2014-2(a).
262. Treas. Reg. § 20.2014-2(b).

credits (but not by any tax credits on prior transfers), that is attributable to the property taxed by and situated in the foreign country and included in the decedent's federal gross estate, as reduced by any charitable or marital deduction.[263] It is stated algebraically as follows:

$$\text{Amount} = \frac{\text{Value of property situated in and taxed by foreign country and included in decedent's federal estate as adjusted for any deduction claimed as an administration expense for foreign taxes and any charitable and marital deduction}}{\text{Value of decedent's federal gross estate less charitable and marital deductions}} \times \text{Federal estate tax less applicable exclusion amount credit and any state gift tax credits}[264]$$

There are important differences between the first and second limitations. The values used for purposes of the second limitation are the values used for federal estate purposes, while the values used for the first limitation are the foreign country's values. Also, if the foreign country applies different death taxes or different rates to different shares or assets of the estate, then for purposes of calculating the second limitation, unlike the first limitation, the different assets or shares of the estate are combined.

If a foreign country's death taxes apply to the decedent's worldwide assets, as in the United States for its citizens and resident aliens, the foreign death tax credit as calculated under the first limitation will be denied with regard to property situated outside the foreign (taxing) country. This disadvantage also applies in the case of the second limitation because the numerator of the ratio does not include such property, thereby reducing the size of the ratio. Also, if foreign-taxed property is used to satisfy a marital or charitable bequest that qualifies for either the marital or charitable deduction, the foreign tax credit will be denied as to that property under the second limitation. If such bequests are satisfied with different property, some of which is foreign-taxed property, a formula applies.[265] To avoid problems, drafters should provide that these types of bequests cannot be satisfied out of

263. I.R.C. § 2014(b)(2).
264. Treas. Reg. § 20.2014-3(a).
265. Treas. Reg. § 20.2014-3(b).

property for which a foreign tax credit is available unless there is no other property to satisfy the bequests.

Even though the foreign death tax has not been paid at the time the federal estate tax return is filed, it may be claimed on the return. Before the credit is allowed, however, Form 706CE must be filed, certifying, among other things, the full amount of the tax, the amount of any credit or allowance, the net foreign death tax payable, and the date or dates of payment of the foreign death tax. The form must include a list of the property subject to the tax, showing the description and value of each item.[266] In this regard, if any interest or penalty is due with the foreign tax, such interest or penalty does not qualify for the credit. Evidence must be submitted showing that no refund is due; if one is due, it must be disclosed.[267] Under section 2016, if any recovery of a foreign death tax for which a credit is claimed occurs, the person recovering the amount must notify the IRS so that the tax can be redetermined. Also, the credit is limited to foreign death taxes actually paid and for which the credit is claimed within four years after filing the federal estate tax return. This time limitation sometimes presents a problem because the determination of the foreign tax may be delayed more than four years after such filing.

The foreign death tax credit is not available to the estates of all resident aliens. If the President of the United States determines that the foreign country of which a resident alien is a citizen does not give U.S. citizens a reciprocal foreign death tax credit, that the country, when requested, has not acted to provide such a credit, and that it is in the U.S. public interest to allow the foreign death tax credit to citizens of such country only if it is reciprocal, the President may proclaim that no foreign death tax credit will be allowed to the citizens of that country unless and until the foreign country allows a similar credit to U.S. citizens.[268]

Finally, it should be noted that there are certain consequences if an election is made under section 6163(a) to postpone the payment of the estate taxes attributable to a reversionary or remainder interest in property. In that case, the state and foreign death tax credits, if any, are allowed against that portion of the federal estate tax to the extent that such state or foreign taxes are attributable to such reversionary or remainder interest if the state or foreign death taxes are paid and if credit is claimed within (1) the time provided for in sections 2011 (for estates of decedents dying before December 31, 2004) and 2014 or (2) the time for payment of the tax imposed by section 2001 or

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266. Treas. Reg. § 20.2014-5(a).
267. *Id.*
268. I.R.C. § 2014(h).

2101 as postponed under section 6163(a) and as extended under section 6163(b).[269]

§ 2:6 Gift Taxation of U.S. Citizens and Resident Aliens

The federal gift tax is an excise tax applicable to lifetime transfers of property that are not for full and adequate consideration. A federal gift tax exemption of $5,000,000 (this amount is indexed for inflation and is $5,340,000 in 2014) and a 40% maximum gift tax rate applies to gratuitous transfers made in 2014.[269.1] Any taxable gifts are reportable and any tax is payable on April 15 of the calendar year following the year in which the gift was completed.

U.S. citizens and resident aliens are subject to gift tax on transfers of property, wherever situated, whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.[270] The donor is liable to pay the gift tax, and if he dies before payment it is an obligation of his estate.[271] The donor can transfer the liability for the tax to the donee by making a net gift to the donee, whereby the donee, as a condition of the gift, agrees to pay the gift tax.[272]

If spouses choose to split the gift, liability is joint and several between them. Gift-splitting permits the gift of property to third persons to be treated for gift tax purposes as if one-half of the property is given by each spouse even though all of the property transferred originally was owned by one spouse. This is an elective right, to which both spouses must consent.[273] It is not available unless each spouse is a U.S. resident or citizen.

Generally, three essential elements are required for every gift. These are an intention on the part of the donor to make a gift, delivery by the

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269. *Id.* § 2015; Treas. Reg. § 20.2015-1(a).

269.1. I.R.C. § 2505; Rev. Proc. 2013-35, 2013-2 C.B. 537.

270. I.R.C. § 2501; Treas. Reg. § 25.2501-1(a)(1).

271. I.R.C. § 2502(c); Treas. Reg. § 25.2502-2.

272. Rev. Rul. 75-72, 1975-1 C.B. 310. *But see* Diedrich v. Comm'r, 457 U.S. 191 (1982), where the Supreme Court held that when a donee pays the applicable gift tax, the payment of such tax is treated as taxable income to the donor. This case has been overruled by statute. Section 1026 of DEFRA provides in part:

> (a) **In General.**—In the case of any transfer of property subject to gift tax made before March 4, 1981, for purposes of subtitle A of the Internal Revenue Code of 1954, gross income of the donor shall not include any amount attributable to the donee's payment of (or agreement to pay) any gift tax imposed with respect to such gift.

See also Davis v. Comm'r, 746 F.2d 357, 364 (6th Cir. 1984) (describing *Diedrich* and DEFRA).

273. I.R.C. § 2513(a)(2).

donor of the subject matter, and acceptance of the gift by the donee.[274] Unless these three elements are present (or deemed present), U.S. courts generally conclude that the gift is not complete. Naturally, no gift tax liability arises until the gift is complete.[275]

Even though gifts may be made indirectly, as by forgiveness of an indebtedness or payment of services for another, they are gifts to which the gift tax will apply.[276] Also, transfers pursuant to the exercise, release, or lapse of a general power of appointment created after October 21, 1942, are taxable.[277] A disclaimer or renunciation of such a power subsequent to 1976, however, is not a taxable gift if certain specific requirements are met.[278] Other provisions applicable to general powers of appointment for gift tax purposes are similar to those discussed previously for estate tax purposes.

No marital deduction from the gift tax is allowed for any lifetime gifts from a U.S. citizen or resident to a non-U.S. citizen spouse.[279] There is no logical reason to distinguish between a transfer of assets by gift and at death. The annual gift tax exclusion for gifts made to a non-U.S. citizen spouse is $145,000 in 2014.[280]

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274. *See, e.g.*, Gruen v. Gruen, 68 N.Y.2d 48, 496 N.E.2d 869, 505 N.Y.S.2d 849 (1986).

275. With respect to certain transfers in trust, there is some authority for the proposition that if, under the applicable state law or the terms of the trust instrument, creditors may be able to reach a portion of the trust, the grantor has not made a completed gift for U.S. federal gift tax purposes until such time as creditors may no longer claim against such trust (*e.g.*, upon expiration of the statute of limitations for such creditors' claims). Outwin v. Comm'r, 76 T.C. 153 (1981); *see also* Priv. Ltr. Rul. 93-32-006 (Aug. 20, 1992); Priv. Ltr. Rul. 87-52-064 (Sept. 30, 1987); Priv. Ltr. Rul. 83-50-004 (Aug. 17, 1983); Gen. Couns. Mem. 38,756 (June 22, 1981).

276. Under I.R.C. § 7872, interfamily loans that carry little or no interest generally are recharacterized as arm's-length transactions in which the lender is treated as having made a loan to the borrower bearing the federal statutory rate of interest. Concurrently, there is deemed to be a transfer in the form of a gift from the lender to the borrower which, in turn, is retransferred by the borrower to the lender to satisfy the accruing interest. In the case of a demand loan or a "gift loan," the imputed interest amount is deemed to be transferred from the lender to the borrower on the last day of the calendar year of the loan. In the case of "gift loans" between individuals where the total amount outstanding does not exceed $100,000, the amount deemed transferred from the borrower to the lender at the end of the year will be imputed to the lender only to the extent of the borrower's annual net investment income. If such income is less than $1,000, no imputed interest is deemed transferred to the lender.

277. I.R.C. § 2514.

278. *Id.* § 2518.

279. *Id.* § 2523(i)(1).

280. *Id.* § 2523(i)(2) (this amount is indexed each year for inflation); Rev. Proc. 2013-35, 2013-2 C.B. 537.

§ 2:6.1 Joint Tenancies with Right of Survivorship

Prior to revisions enacted by ERTA, certain specific rules applied to the creation of tenancies by the entirety or joint tenancies with right of survivorship of real and personal property.

As to real property, such a tenancy was not treated as a gift unless the donor spouse elected it to be a gift by the timely filing of a gift tax return, in which case a "qualified joint interest" was created and each spouse was deemed to own one-half for estate tax purposes.[281] If the election was made, gift tax returns were required to be filed each year for additions to the property and mortgage payments in excess of the annual exclusion, if only one spouse made such additions or payments. The creation of a joint tenancy in personalty constituted a gift to the extent that the donor spouse's interest exceeded the interest he retained.[282]

Under ERTA, in the case of property jointly owned with the right of survivorship, spouses are automatically deemed to be 50% owners. Thus "qualified joint interest" election rules are no longer necessary and are repealed.[283]

For gift tax purposes, the value of property transferred is the fair market value of the property on the date of the gift. It is the price for which the property would sell, given a willing seller and buyer who are not under any compulsion and who have reasonable knowledge of the relevant facts.[284] Of course, if the property is available in the retail market, the value is the retail price. If there is a transfer for consideration that does not equal the value of the property transferred, the excess is deemed a gift.

However, in the case of tenancies by the entirety, or joint tenancies with a right of survivorship, in real or personal property created after July 13, 1988, TAMRA re-enacted the principals of sections 2515 and 2515A, previously repealed by ERTA, for the joint tenancies between spouses where at least one spouse is a non-U.S. citizen.[285]

In the case of a joint tenancy in real property, there is a gift at the termination of the tenancy, other than by reason of the death of a

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281. I.R.C. § 2515, *repealed by* ERTA, Pub. L. No. 97-34, § 403(c), 95 Stat. 172, 301–02.
282. I.R.C. § 2515A, *repealed by* ERTA, Pub. L. No. 97-34, § 403(c), 95 Stat. 172, 301–02.
283. ERTA, Pub. L. No. 97-34, § 403(c), 95 Stat. 172, 301-02. See section 4:5 *infra* for a discussion of I.R.C. § 2040.
284. I.R.C. § 2512; Treas. Reg. § 25.2512-1.
285. I.R.C. § 2523(i)(3). However, the principles under former section 2515 now apply without the election to treat a joint tenancy in real property as a gift at the time of its creation formerly available under § 2515.

spouse, to the extent that a spouse receives proceeds on termination greater than the proportion of the total consideration furnished by that spouse multiplied by the total proceeds on termination.[286] Conversely, it appears that with respect to tenancies by the entirety, or joint tenancies with a right of survivorship, in personal property, that are created after July 13, 1988, each spouse is deemed to have made a gift upon the creation of the joint tenancy of one-half of the consideration furnished by each spouse.[287] Special rules apply to certain personal property interests. For example, a gift is not deemed to occur on the creation of a joint bank account.[288] However, at the time of withdrawal from the account, or at its termination, there is a gift to the extent that either spouse receives a greater portion of the account balance than he or she contributed.[289]

§ 2:6.2 Computation of Gift Tax

The federal gift tax is cumulative and is determined by computing a tentative tax on the taxable gifts made for the applicable return period, plus taxable gifts made since June 6, 1932, and subtracting from the tentative tax so calculated a tentative tax applicable only to the prior gifts. Once the tax is determined, that portion of the applicable exclusion amount credit that has not previously been used is subtracted from the tax to reduce or eliminate the tax payable. The credit must be taken as the gift tax liability arises. Also, a husband and wife can each claim a credit even if the gifts to third persons are made from one spouse's property, provided they both consent to splitting the gift as if each had given one-half of the property.

If spouses split their gifts and the "string provisions" (sections 2035 through 2038) otherwise apply, the property is includible in the estate of the spouse who provides the property. If the string provisions do not apply, the statute seems to provide that one-half of the property will not be included in the gifts that comprise the adjusted taxable gift amount when the estate is "grossed up" to determine the estate tax. To the extent gift taxes do not exceed the credit, that credit is, in effect, available for federal estate tax purposes. This method of calculating the gift tax causes the applicable rate of tax to increase as taxable gifts are made.

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286. *Id.* § 2515(b), *repealed by* ERTA, Pub. L. No. 97-34, § 403, 95 Stat. 172, 301–02, *and re-enacted by* I.R.C. § 2523(i)(3).
287. *Id.* § 2515A, *repealed by* ERTA, Pub. L. No. 97-34, § 403(c), 95 Stat. 172, 301–02, *and re-enacted by* I.R.C. § 2523(i)(3).
288. Treas. Reg. § 25.2511-1(h)(4); *compare* Gen. Couns. Mems. 37,689 (Sept. 25, 1978), 37,310 (Nov. 2, 1977), 36,647 (Mar. 23, 1976).
289. Treas. Reg. § 25.2511-1(h)(4).

§ 2:6.3 Annual Exclusion

Taxable gifts are the gross amount of gifts, less an annual exclusion, in 2014, of $14,000 per donee ($28,000 if the spouse joins in the gift), and less any applicable charitable or marital deductions. The annual exclusion for gifts is indexed annually for inflation (in increments of $1,000). In 2014, the annual exclusion in the case of transfers to a non-U.S. citizen spouse is $145,000.[290] In addition, the Code permits an unlimited gift tax exclusion for amounts paid on behalf of a donee directly to an educational organization for tuition and to a healthcare provider for medical services (no special relationship need exist between the donor and the donee).[291]

In order to qualify for the annual exclusion, the gift must be of a *present* interest in property, with exceptions for certain gifts to minors and certain contributions to an individual retirement account for a nonworking spouse. The classification of an interest as present or future for this purpose turns on the certainty of immediate enjoyment. The Treasury Regulations define "future interest" as follows:

> "Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note . . . , or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument or transfer used in effecting a gift.[292]

The Treasury Regulations also state that an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property."[293] The exclusion is allowable only to the extent of the value of a present interest at the time of the gift up to the annual exclusion amount regardless of the size of the gift.

If the gift is of the income from a trust, the income must be payable immediately or within a reasonable time. The trustee should not be

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290. I.R.C. § 2523(i)(2) (stating that this amount must be in a form that qualifies for the marital deduction under section 2523, without regard to section 2523(i)). *See also infra* note 319; Rev. Proc. 2013-35, 2013-2 C.B. 537.
291. I.R.C. § 2503(e).
292. Treas. Reg. § 25.2503-3(a).
293. Treas. Reg. § 25.2503-3(b).

given the right to accumulate[294] or otherwise direct the income from the beneficiary for other purposes (for example, payment of taxes).[295] If he has such a right, the income interest is considered a future interest, with two exceptions:

1. Gifts of future interests to minors qualify if the property or income may be used by or for the minor prior to his attaining twenty-one years of age, and the property not so used passes to him at the time he attains twenty-one. Also, if the minor dies before becoming twenty-one, the property must pass to his estate or as he appoints under a general power of appointment. This latter requirement would cause the property to be includible in his estate for estate tax purposes.[296]

   This exception is frequently used by donors and is a good estate planning tool. It applies even though a provision in the trust permits the minor beneficiary to extend the trust or provides that the trust will extend automatically if the minor does not terminate it during a limited, reasonable period of time after the minor has attained twenty-one years of age.[297]

2. Contributions made by a working spouse to a spousal IRA escape gift tax liability in tax years beginning after 1981 due to the operation of the unlimited marital deduction. However, section 2503(c), prior to its repeal for tax years beginning after 1981, provided that payments (up to $10,000 per year) made by a spouse for certain retirement accounts for his or her nonworking spouse, who would not enjoy any benefit from these accounts until the nonworking spouse attained fifty-nine and one-half years of age, as required by rules governing the same, qualified as a present interest.[298]

For gifts made to a trust, there is an exclusion for each beneficiary who has or is deemed to have a present interest in the trust.[299] If a beneficiary has interests in more than one trust created by the same donor, there is only one exclusion. If the donor and the donor's spouse split the gift, there is a $10,000 exclusion per donee for each spouse, which is indexed for inflation beginning in 1999. A gift in the amount of $10,000 or less is not part of the taxable gifts used for computing

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294. Welch v. Paine, 120 F.2d 141 (1st Cir. 1941).
295. Comm'r v. Brandegee, 123 F.2d 58 (1st Cir. 1941).
296. I.R.C. § 2503(c)(2)(B).
297. Rev. Rul. 74-43, 1974-1 C.B. 285, *revoking* Rev. Rul. 60-218, 1960-1 C.B. 378.
298. I.R.C. § 2503(d), *repealed by* ERTA, Pub. L. No. 97-34, 95 Stat. 172.
299. Helvering v. Hutchings, 312 U.S. 393 (1941).

the gift tax as described above or for "grossing up" the donor's estate for estate tax purposes.[300]

§ 2:6.4 Charitable Deductions

Charitable contributions are deductible for gift tax purposes in the same manner as for estate tax purposes. Thus, to qualify for such deductions, the gift must be to or for the use of the United States or a governmental subdivision thereof for exclusively public purposes or to a qualified charity for its charitable purposes.[301] Like the estate tax charitable deduction, the gift tax deduction is not limited to gifts for use in the United States or to domestic charities. Thus, gifts to foreign organizations that meet the charitable purpose test for use outside the United States are also deductible. Also, the deduction is not limited to the percentage limitations applicable to charitable deductions for income tax purposes.

The rules on the deductibility of certain split-interest gifts (charitable and noncharitable donees) for gift tax purposes are similar to the rules for estate tax purposes and are governed by complicated and technical provisions that are beyond the scope of this discussion.[302]

§ 2:6.5 Marital Deduction

The gift tax marital deduction is a deduction for the value of certain property interests transferred to the donor's spouse. For gifts made after 1981, the marital deduction is unlimited.[303] The interest must be a deductible interest, which is defined as an interest transferred from a donor to his spouse that is not a "nondeductible interest."

Nondeductible interests are terminable interests[304] and any property not included in the total amount of the gifts made during the relevant calendar year, which includes property that qualifies for the annual exclusion.[305] As with the estate tax marital deduction, ERTA provides that interspousal transfers of community property qualify for a gift tax marital deduction for gifts made after 1981.[306]

The rules governing terminable interests are similar to those for estate tax purposes. The marital deduction is available only if the donor's spouse is a citizen of the United States; however, the marital deduction is allowed for certain transfers in trust to a surviving spouse

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300. I.R.C. § 2503(b). Such amount is $14,000 in 2014. Rev. Proc. 2013-35, 2013-2 C.B. 537.
301. *Id.* § 2522.
302. *Id.* § 2522(c); *see id.* § 2055(e).
303. *Id.* § 2523(a).
304. Treas. Reg. § 25.2523(a)-1(b)(3).
305. *Id.*
306. ERTA, Pub. L. No. 97-34, § 403(b)(1)(a), 95 Stat. 172, 301.

who is not a U.S. resident.[307] If both the annual exclusion and the marital deduction apply, the annual exclusion is calculated before the marital deduction is determined. The same rule applies with regard to the charitable deduction.

§ 2:7 Generation-Skipping Transfer Tax

The first generation-skipping transfer tax was enacted by the 1976 Act. Prior to that, it was possible for a family to pay a transfer tax (such as the gift or estate tax) only once every several generations. For example, if a trust were established with income payable to the grantor's child for life, then to the grantor's grandchild for life with remainder over to the grantor's great-grandchild, no transfer tax was imposed upon the death of either the grantor's child or grandchild. Eventually, an estate tax would be payable upon the death of the remainderman to the extent the principal had been paid over or distributed to the remainderman and was thereby includible in his estate.

The generation-skipping transfer tax was enacted to prevent the avoidance of transfer taxes over a period of successive generations. The original generation-skipping transfer tax applied to generation-skipping transfers resulting from generation-skipping trusts or trust equivalents. The tax proved to be tremendously complex to both taxpayers and the IRS.[308] The 1986 Act repealed the original generation-skipping transfer tax[309] and replaced it with a new transfer tax applicable to all generation-skipping transfers whether by way of a trust, trust equivalent, or direct transfer.

The Tax Act of 2001, the Tax Act of 2010 and the Tax Act of 2012 have made significant changes that impact the federal generation-skipping transfer tax, as well as the federal estate tax and the federal gift tax. Pursuant to the Tax Act of 2001, the top federal generation-skipping transfer tax rates decreased together with the top estate tax and gift tax rates. In addition, the generation-skipping transfer tax exemption increased from 2002 through 2009, when it reached $3,500,000, like the estate tax exemption. For years 2003 through 2008, furthermore, the generation-skipping transfer tax exemption was adjusted for inflation. In 2010, the generation-skipping transfer tax exemption was $5,000,000 with a rate of 0%. In 2011 and 2012,

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307. I.R.C. § 2056(d)(2).
308. *See* J. Hellige & W. Weinsheimer, *A New Set of Complexities*, TR. & EST., Mar. 1987, at 8.
309. The pre-1986 generation-skipping transfer tax was repealed retroactively to June 11, 1976. A credit or refund (with interest) may be obtained for a tax paid thereunder. 1986 Act, Pub. L. No. 99-514, § 1433(c), 100 Stat. 2085, 2731–32.

the generation-skipping transfer tax exemption was $5,000,000 with a rate of 35%. Pursuant to the Tax Act of 2012, the generation-skipping transfer tax exemption is $5,000,000 (as indexed for inflation; such amount is $5,340,000 in 2014) imposed at a flat rate of 40%.[310]

In order to understand the methodology of the generation-skipping transfer tax, it is necessary to become acquainted with several statutory terms and definitions. Most basic to the statute are the definitions of the "transferor" and a "generation," which are dealt with in sections 2652(a) and 2651 of the Code, respectively. The transferor is the decedent, if the transfer is of the type subject to the estate tax, the transferor is the donor, if the transfer is of the type subject to the gift tax.[311] Generally, a generation is defined along family lines. Thus, the transferor, the transferor's spouse, and the transferor's siblings are assigned to one generation while their children are considered to be the next generation and their grandchildren are in the generation following the children. If the generation-skipping transfer is made outside the family, generations are determined by ages as defined in the Code.[312] Persons assigned to a generation two or more generations below that of the transferor's generation are known as "skip persons."[313]

There are three types of generation-skipping transfers:

(1) taxable terminations,
(2) taxable distributions, and
(3) direct skips.[314]

A taxable termination occurs upon the termination of an interest in a trust[315] if after such termination all interests in the trust are held by skip persons.[316] A person has an interest in the trust if such person

(1) has a right (other than a future right) to receive income or principal from the trust,
(2) is a permissible current recipient of income or principal of the trust, or

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310. I.R.C. §§ 2631(c) and 2641(a); Rev. Proc. 2013-35, 2013-2 C.B. 537.
311. I.R.C. § 2652(a).
312. *Id.* § 2651(d).
313. *Id.* § 2613(a).
314. *Id.* § 2611(a)(3).
315. The generation-skipping transfer tax rules apply to both trusts and trust equivalents. *Id.* § 2652(b)(1). For convenience, however, the term "trust" is used throughout this discussion. Examples of trust equivalents are life estates and remainders, estates for years, and insurance and annuity contracts.
316. I.R.C. § 2612(a).

(3) is a unitrust or annuity recipient of a charitable remainder unitrust or annuity trust or a pooled income fund.[317]

> *Example:* The transferor creates a trust paying income to his daughter for life, and, upon the daughter's death, the trust remainder is to be distributed outright to the transferor's grandson. A taxable termination occurs at the daughter's death since an interest in a trust has terminated and no one but skip persons has an interest in the trust after the terminating event.

A taxable distribution occurs when there is a distribution of principal or income from a trust to a skip person unless the distribution also is a taxable termination or a direct skip.[318] The amount of the generation-skipping transfer tax paid from the trust with respect to the taxable distribution is also treated as a taxable distribution.[319]

> *Example:* The transferor creates a sprinkling trust providing for the payment of income or principal to the transferor's children and grandchildren. A distribution of income or principal from the trust to a grandchild is a taxable distribution.

A direct skip occurs when property is transferred to a skip person, and such transfer is subject to the estate or gift tax.[320] A gift by a grandparent to a grandchild constitutes a direct skip. A transfer to a grandchild made before January 1, 1990, that would otherwise qualify as a direct skip, will not be subject to the generation-skipping transfer tax to the extent that the total transfers from the transferor to such a grandchild do not exceed $2 million.[321]

Under the Tax Act of 2001, all transferors were entitled to a $1 million exemption from the generation-skipping transfer tax, which was indexed for inflation beginning in 1999. The 2010 Act provides a $5 million lifetime GST exemption for 2010 (equal to the exclusion for federal estate tax purposes) with a GST tax rate of zero percent for 2010. For transfers made after 2010, the GST tax rate would be equal to the highest estate and gift tax rate in effect for the year (40% for 2014). Under current law, the generation-skipping transfer tax exemption is $5,000,000 (as indexed for inflation) with a flat rate of 40% for transfers on or after January 1, 2013.[321.1] The exemption may be allocated by the transferor or the executor of the

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317. *Id.* § 2652(c)(1).
318. I.R.C. § 2612(b).
319. *Id.*
320. *Id.* § 2612(c).
321. 1986 Act, Pub. L. No. 99-514, § 1433(b)(3), 100 Stat. 2085, 2731.
321.1. I.R.C. § 2631; Rev. Proc. 2013-35, 2013-2 C.B. 537. Such exemption is $5,340,000 in 2014.

transferor's estate.[322] A married couple may elect to treat generation-skipping transfers as being made one-half by each spouse.[323] Once the exemption is used, the appreciation in value of the exempt property also is exempt from the generation-skipping transfer tax.

> *Example:* The transferor creates and funds a $5 million trust for his grandchildren in 2011 and allocates his entire $5 million exemption to the trust. No part of the trust will be subject to the generation-skipping transfer tax even if the value of the trust appreciates.

The amount subject to the generation-skipping transfer tax and the person liable for the tax differ depending on whether the generation-skipping transfer is a taxable termination, a taxable distribution, or a direct skip. In the case of a taxable termination, the taxable amount is the value of the property with respect to which the termination has occurred reduced by deductions similar to those allowed by section 2053 of the Code.

The amount taxable with respect to a taxable distribution is the value of the property received by the transferee reduced by the expenses incurred by the transferee in connection with the determination, collection, or refund of the generation-skipping transfer tax imposed with respect to the distribution. If the tax is paid out of the trust, the amount of the tax is treated as a taxable distribution.

Finally, the taxable amount in the case of a direct skip is the value of the property received by the transferee.[324] The tax on a direct skip from a trust is to be paid by the trustee, and in the case of other direct skips, by the transferor.[325]

To compute the generation-skipping transfer tax, the taxable amount is multiplied by the applicable rate.[326] Unless an exemption or some special rule applies, the generation-skipping transfer tax rate will be equal to the maximum estate tax rate (40% in 2014) multiplied by the inclusion ratio with respect to the transfer.[327]

Although the generation-skipping transfer tax has been in existence for some time, there still are many unanswered questions. The foregoing discussion of the statute is meant to serve as a general overview. Treasury Regulations made effective on December 27, 1995,

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322. I.R.C. § 2631(a).
323. *Id.* § 2652(a)(2).
324. I.R.C. § 2623.
325. *Id.* § 2603(a)(2), (3).
326. *Id.* § 2602.
327. *Id.* § 2641. The inclusion ratio is calculated under a complicated formula that takes into account the value of the transferred property, any taxes paid or deductions taken with respect to such property, and any exemption allocable to such property. *Id.* § 2642.

to some extent clarify the application of the statute with respect to transfers by nonresident aliens subject to the generation-skipping transfer tax.[328]

§ 2:8 Conclusion

The rules pertaining to the federal estate and gift taxation of nonresident citizens and resident aliens are complex. The foregoing discussion is only intended to be an overview of those rules, which are not only the basis for taxation of those persons but also are important with regard to the federal estate and gift taxation of nonresident aliens discussed in the next chapter.

328. Treas. Reg. § 26.2663-2. *See infra* section 3:7.