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Deathbed Planning: What options are available during the three years before a client's demise?

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Deathbed Planning

What options are available during the three years before a client’s demise?

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It has long been accepted as nearly axiomatic, from a wealth tax planning perspective, that lifetime gifts and other transfers are more efficient than deathtime transfers. Two common reasons account for this. First, the gift tax on lifetime transfers is computed on a “tax exclusive” basis (that is, the gift tax paid is not itself subject to gift tax); but the estate tax on deathtime transfers is computed on a “tax inclusive” basis (that is, the estate tax paid is itself subject to estate tax). Second, appreciation and income (together referred to as “growth”) arising after the lifetime transfer are subject neither to gift tax nor estate tax with respect to the transferor.

Another advantage that lifetime gifts produce derives from the annual exclusion. Gifts that qualify for the exclusion are removed from the tax base, escaping transfer tax entirely. Still another (though rarely mentioned) advantage relates to state wealth transfer tax. Very few states have a gift tax, but many have or are in the process of adopting state death taxes. Hence, the combined federal and state death tax rates may be much higher than the federal gift tax rate.

Some factors, however, may make lifetime transfers less efficient than deathtime transfers—or at least reduce their advantage. First, if the lifetime gift triggers an obligation to pay gift tax, the donor will suffer an opportunity cost: The amount of the gift tax paid by the donor no longer will be available to produce income or interest. Second, lifetime gifts ordinarily—but not always—entail a cost in terms of the recipient’s basis for income tax purposes. The basis of property transferred by lifetime gift is the donor’s basis (plus the federal gift tax imposed on any inherent appreciation in the asset transferred), often referred to as carryover basis. The basis of property transferred at death, on the other hand, is subject to exceptions, the asset’s estate tax value. Hence, where basis is important to the recipient of the property (because it may be subject to an allowance for depreciation or will be disposed of after the gift in a taxable transaction), the carryover basis, if lower than the value of the asset at the time of the donor’s death, will result in a greater income tax liability for the recipient. In some cases, however, the carryover basis will be higher than the value of the asset at the donor’s death, which actually may result in an income tax savings for the recipient if the gift is made during lifetime.

Third, while payment of gift tax

Some factors make lifetime transfer less efficient—or at least reduce their advantages over transfers at death.
Because of the reduction in rates through 2009, less of a credit may occur than the amount of gift tax paid. That disadvantage is made more acute if the transferor dies in 2010.

the gift. Because of the reduction in estate and gift tax rates scheduled to occur through 2009, less of a credit may occur than the amount of gift tax actually paid. That disadvantage, of course, is made all the more acute if the transferor of a lifetime gift upon which federal gift tax is paid dies in 2010 when the federal estate tax will be eliminated under current law.

In addition, given the increase in the estate tax applicable exclusion amount scheduled under current law and the fixed nature of the gift tax applicable exclusion amount, there is further potential for "wasted" gift tax payments. (On the other hand, under current law, a lifetime gift upon which the highest gift tax is paid between 2002 and 2009 may have a "calculation" advantage if the transferor dies after 2010, because the federal estate tax including the 55 percent top rate, which is some cases could be 60 percent, is then restored.)

Needless to say, all of these and other factors make it complicated, and perhaps even uncertain, to determine how much, if any, advantage will be gained by making transfers during life rather than upon death. Nevertheless, it is certain that taxable gifts will continue to be made by many taxpayers, and in some cases those gifts will be made within three years of death. Where such transfers within three years of death are made, additional consequences and considerations may arise.

Special Three-Year Rule
A decedent's gross estate may include far more than the assets that the decedent owned at death. For example, 1) property that the decedent transferred during lifetime but over which he retained and held at death the right to income, the power to control the beneficial enjoyment of the property, the right to vote certain closely-held stock or a reversionary interest or, b) held at death the power to control the beneficial enjoyment of such transferred property, and 2) death proceeds paid under a policy of insurance on his life and over which he held at death any "incident of ownership" are included in the decedent's gross estate. Often such inclusion is quite disadvantageous, because the value of the interest held before death is much smaller than the amount that will be included in the decedent's estate. Hence, it usually is preferable to eliminate any such right, power or interest to avoid such estate tax inclusion.

Internal Revenue Code Section 2035, however, provides that, if the decedent made a transfer of an interest in any property or relinquished a power with respect to any property within three years of death and the value of the property would have been included in the gross estate under one of the designated sections (2036, 2037, 2038 or 2042) if the interest had been retained, the value of the gross estate includes the value of the property that would have been included in the gross estate had the transfer or relinquishment not occurred. As indicated, the purpose of the Section 2035 rule is to prevent taxpayers who have retained one of these powers or interests from relinquishing it shortly before death just to avoid the impact of these sections. Nevertheless, the three-year rule is rendered inapplicable by an exception for any bona fide sale for an adequate and full consideration in money or money's worth.

Interesting questions can arise, however, as to the amount of consideration that must be present to trigger the exception. In Allen v. U.S., the taxpayer had retained the right to income from a trust she had created. This right would have caused the entire trust to be included in her estate under IRC Section 2036(a)(1). The taxpayer was quite old and, as a result, the value of the income interest she held was quite limited. At that time, IRC Section 2035 provided that any gift made within three years and in contemplation of death caused the property to be included in the transferor's estate. To avoid the application of the section, the taxpayer sold her income interest for its present value. Although such a full-value sale would appear to negate the section (as there was no gift but rather a sale), the court held the entire trust had to be included in her estate on the grounds that Congress had not intended it to be so easy to avoid the estate tax.

IRC Section 2035 was later amended to exclude transfers within three years of death from the transferor's gross estate, except where the interest transferred would have caused estate tax inclusion under IRC sections 2036, 2037, 2038 or 2042. In so doing, Congress explicitly indicated its intent that the then-existing law with regard to the relinquishment of such retained interests or pow-
ers would continue to govern. If such an application is made under the current statute, a sale of the interest for its value that if held until death would have caused estate inclusion under one of the foregoing sections would not be effective in avoiding the application of IRC Section 2035(a).

Some courts have questioned Allen. Nevertheless, even if Allen remains fully viable, it appears that the section can be avoided by having the taxpayer purchase the other interests in the property that otherwise would be included in his estate under IRC sections 2036, 2037, 2038 or 2042. Although that would make the entire property in which the taxpayer had an interest included in his gross estate, his estate would be depredated by the consideration paid for the interest in the property that the taxpayer did not own prior to the purchase.

Estate Tax on Gift Tax
As indicated, the IRC contemplates that lifetime gifts generally will enjoy three advantages: post-transfer growth is eliminated from the wealth transfer tax base; annual exclusion gifts are completely exempting from transfer taxation; and the tax is computed on a tax exclusive basis. However, IRC Section 2035(b) eliminates the last of these advantages when the gift is made within three years of death. In such a case, the section provides that the amount of gift tax paid by the decedent or his estate on any gift made by the decedent (or his spouse18) must be added to the gross estate.

The impact of the inclusion of the gift tax in the estate may vitiate any advantage of a lifetime transfer made within that time frame. For, if death occurs within the three-year period, the estate fails to secure the tax exclusive advantage ordinarily inherent in lifetime gifts, and yet may forfeit the opportunity to enjoy the IRC Section 1014 basis "step-up." In other words, depending on post-transfer events, it may be more tax efficient for the asset to be part of the gross estate in order to secure the basis step-up. It may, therefore, be appropriate to make the transfer to a trust that would provide, depending on how post-transfer events evolve, for the property either to be returned to the decedent’s probate estate (or be made in such a case to a special or general power of appointment) so as to be included in the decedent's gross estate or to remain in the trust. Surprisingly, where this technique is utilized and the donor lives for at least three years, it may even be possible to secure the tax exclusive advantage while, at the same time, enjoying a basis step-up under Section 1014.

In any event, whether or not the property given away within three years of death is included in the transferor’s gross estate, IRC Section 2035(b) will cause the gift tax on such gift to be included in the gross estate. That, in turn, raises the question of which party must bear the burden of this additional estate tax. Under the law of most states, the party who receives, or holds, the interest in the taxable estate must pay the estate tax attributable by that interest. Nevertheless, at least within limits, the decedent may direct where the burden of estate tax lies; although usually any such direction contrary to the estate tax apportionment provided under state law must be clear and unambiguous. In any case, where a testator directs that all taxes due by reason of his death on property passing under the will and outside of the will is to be charged against and paid without apportionment from his probate estate (probably the most common apportionment clause used in wills), the estate tax on the gift tax included under IRC Section 2035(b) would seem to be payable by the residue of the probate estate. Hence, the recipient of the gift would not bear the burden of the estate tax.

However, the consequences of such a tax apportionment direction may be far reaching. First, the burden of the estate tax will be born by the residuary legatees, who usually are the principal beneficiaries of the decedent. That result may not be what the decedent intended. Second, if the residue of the probate estate otherwise qualifies for the estate tax marital or charitable deduction, the deduction will be reduced by the estate tax due on the gift tax, thereby increasing the estate tax.

If the decedent has not made such a direction with respect to apportionment, the burden of the estate tax on the gift tax paid on gifts made within three years of death will be determined by the state apportionment rules. As mentioned, most state apportionment statutes provide that the tax burden generated by the property included in the estate must be paid by the person who receives or holds the interest that generates the tax. But, of course, the gift tax will be held by the Internal Revenue Service. And it is virtually certain that the IRS will not be held to be responsible to pay the estate tax on the gift tax. In Private Letter Ruling 9339010 (not precedent) it was held in effect that the estate tax would not be apportioned against the IRS.

In any case, it does not appear that any state death tax apportionment statute currently provides a clear rule of where the burden of estate tax on the gift tax is chargeable. It seems that it will be determined that the burden of the tax will fall in one of two places. First, the burden might fall on the recipient of the gift on the theory that the recipient should be treated as
having the property interest that is included in the estate. That seems consistent with the purpose and history of IRC Section 2035. Second, the burden might fall on the decedent’s probate estate on the theory that the tax should be treated in the same fashion that any other lifetime gift is treated (ordinarily, the recipient of a lifetime gift is not required to contribute under apportionment statutes to any estate tax liability generated by the gift). A similar result was reached in Bunting v. Bunting. In Bunting, the testator made a lifetime gift to his son upon which federal gift tax was due. He later executed his will providing that all estate and transfer taxes be paid out of the residue. The residue was given to his children equally. The testator died within three years of the lifetime gift. The estate tax exceeded the burden of such tax should fall, it certainly will not reflect what every taxpayer would want. Hence, it seems that the better practice is to have the transferor and the recipient of any gift that could generate gift tax reach an agreement as to who will shoulder the burden of the estate tax on any gift tax liability triggered as a result of death within the three-year window. For example, the transferor and the recipient might execute an agreement similar to the following:

Have a transferor and a recipient of any gift that might generate a gift tax contract as to where the burden should fall.

At least two cases have dealt with the issue. In Matter of Phyllis Kennedy, the decedent directed that all death taxes were to be paid as an expense of administration of her estate to the extent of property owned by her and passing under her will. She further directed that all death taxes in respect of any other property were to be apportioned and paid by the persons in possession thereof or benefited thereby “in the manner provided by law.” The court held the recipients of the gifts made within three years of her death had to pay the Section 2035(b) estate tax on the gift tax. The court’s decision is based, at least in part, on the particular tax apportionment provision contained in the will. But the court did note that its construction was consistent with certain rules of construction that are well established under New York law: the preference for maximizing the surviving spouse’s interest; the presumption that testators wish to minimize estate tax and therefore ordinarily seek to avoid placing the burden of the tax on bequests that would otherwise qualify for the charitable or marital deduction; and the preference for equitable apportionment of estate tax.

Buntiong, it may be reasonable to conclude that, unless the decedent directs otherwise, the recipient of the gift will have to bear the burden of the estate tax on the gift tax paid on gifts made within three years of death. However, the law is not so well developed as to make that a certainty. Regardless of how states determine where the
the recipient might execute an agreement similar to the following, if the transferor will be burdened with the estate tax:

"This is a contract between Jane Doe ('Jane') and John Smith ('John'), together referred to as the "parties". Jane is contemplating making a gift of [description of gift] to John. The parties agree as follows. Jane acknowledges that if she makes the gift she is responsible for any gift tax that will be generated by that gift and agrees to pay it. The parties realize that if Jane dies within three years of that gift, any Federal gift tax paid by Jane or her estate will be included in her estate for Federal estate tax purposes, and Federal estate (and possibly state death) tax may be

were reduced on account of the donee's obligation to pay the estate tax attributable to the Section 2035(b) inclusion, the reduction would have to be offset by an inclusion in the donor's estate, presumably under IRC Section 2033: the right of the donor's estate to have the donee pay that portion of the tax represents a claim that would have to be included in the gross estate. Thus, no reduction would appear to be permitted, and therefore no tax savings can apparently be achieved by having the donee undertake to pay any tax generated by the Section 2035(b) inclusion.

In some cases, it may be more appropriate (or at least possibly safer) to have the transferor pay the estate tax on the gift tax. For example, the grantor of a lifetime charitable remainder trust (CRT) must agree to apportion any estate tax on a CRT if included in his gross estate to a source other than the CRT. Although the ruling does not by its terms expressly apply to estate tax on any gift tax paid by the grantor on the CRT gift, it is virtually certain the IRS would contend the ruling is intended to cover the estate tax on such gift tax. Although not developed with respect to charitable lead trusts, it may be prudent—to avoid any argument that the amount to be so deducted cannot be reasonably calculated on account of the possibility of estate tax being imposed on the trust with respect to the gift tax paid on its creation if death occurs within three years—to have the grantor agree to have any such estate tax paid from another source.

Other Three-Year Rules
Steps taken during a client's life can have an important impact for estate tax purposes. One of the reasons is that the federal estate and gift tax systems have many differences in addition to those already mentioned. For example, a decedent's estate may elect to pay the federal estate tax under IRC Section 6166 in installments following death attributable to certain closely held business interests in the estate, in some cases. No comparable payment schedule is allowed for gift tax purposes. In addition, real estate used in a farm or other closely held business may be specially valued (below its fair market value) under IRC Section 2032A for estate tax purposes, in some cases, if the adjusted value of the gross estate is comprised 50 percent or more of qualifying business interests and at least 25 percent consists of qualifying real estate. No comparable special valuation is permitted for gift tax purposes.

The IRC even offers an estate certain income tax benefits that do not apply with respect to lifetime transfers. For example, although distributions, even in redemption of stock, from a corporation normally are taxable under IRC Section 301 as ordinary income as dividends, IRC Section 303 treats certain after death redemptions of stock to pay death taxes and estate administration expenses as sales proceeds (and, therefore subject to capital gains treatment) if the estate meets a more-than-35 percent test similar to that, discussed below, con-

The ability to use IRC sections 6166, 2032A or 303 is dependent upon the estate meeting certain qualifications.

due on such gift tax. Jane agrees that her probate estate [alternative: name of her Revocable Trust] will bear the burden of, and will pay any such estate tax, without apportionment and without any right of reimbursement from John, and agrees to maintain a clear and unambiguous direction in her will [alternative: name of her Revocable Trust] to have such tax paid by her probate estate [alternative: property disposed of under the name of her Revocable Trust].

If the first approach is taken, the question becomes whether the recipient's agreement to pay the tax should effect a reduction in the amount of the taxable gift (using as an analogy the net-gift methodology). Recently, the courts have held that such a reduction is not permissible. Indeed, the U.S. Tax Court concluded that, even assuming the amount of the taxable gift estate tax on the gift tax. For example, the grantor of a lifetime charitable remainder trust (CRT) must agree to apportion any estate tax on a CRT if included in his gross estate to a source other than the CRT. Although the ruling does not by its terms expressly apply to estate tax on any gift tax paid by the grantor on the CRT gift, it is virtually certain the IRS would contend the ruling is intended to cover the estate tax on such gift tax. Although not developed with respect to charitable lead trusts, it may be prudent—to avoid any argument that the amount to be so deducted cannot be reasonably calculated on account of the possibility of estate tax being imposed on the trust with respect to the gift tax paid on its creation if death occurs within three years—to have the grantor agree to have any such estate tax paid from another source.


However, as indicated, the ability to use IRC sections 6166, 2032A or 303 is dependent upon the estate meeting certain qualifications. For instance, among other conditions, an estate may elect to pay estate tax under IRC Section 6166 only if more than 35 percent of the decedent’s adjusted gross estate (as defined in that section) is comprised of qualifying closely-held business interests. Needless to say, including property transferred during lifetime in the gross estate (and, therefore, in the adjusted gross estate) could cause an estate to fail or to pass the more-than-35 percent threshold. IRC Section 2035(c)(2) requires that the estate meet the more-than-35 percent test only if it meets it both by determining the adjusted gross estate without regard to property included in the gross estate under IRC Section 2035 (for example, a gift of a retained income interest to try to prevent the application of inclusion of the underlying property under IRC Section 2036) and with regard to such property. This means that any action that attempts to avoid the application of IRC Section 2036, Section 2037, Section 2038 or Section 2042 by a gift ought to take into account the potential impact on the allowance to pay the estate taxes pursuant to IRC Section 6166, just in case death occurs within three years of the gift.

A special transfer-within-three years-of-death rule also applies to determine if the estate qualifies for special valuation under IRC Section 2032A. Unlike the special rule contained in IRC Section 2035(c) for IRC Section 6166 purposes, where two calculations are required and applies only to property included in the gross estate under IRC Section 2035(a), IRC Section 2035(c)(1) provides one special test: the determination of whether the estate meets the IRC Section 2032A 50 percent or more and 25 percent or more tests for qualification is made by including in the gross estate all property of which the decedent has made a transfer by trust or otherwise within in three years of death (apparently, whether or not otherwise included in the gross estate under IRC Section 2035(a)). No second or alternative calculation must or can be made for purposes of qualifying. A similar rule is contained in IRC Section 2035(c)(1) for the more-than-35 percent test of IRC Section 303. (The section also con-
One practical difficulty using the deathbed annual exclusion gift occurs where the gift is made by a check that fails to clear the bank before the donor’s death.

...current calendar year, gifts equal to the exclusion should be made to as many donees as possible and desirable before death. One practical difficulty that may arise in using deathbed annual-exclusion gifts occurs when the gift is made by a check that fails to clear the bank before the donor’s death. Revenue Ruling 96-56, 1996-2 C.B. 161, makes clear that, if the check fails to clear (or is not otherwise accepted by the bank) before the donor’s death, the gift is incomplete and the entire balance in the account remains part of the gross estate. Thus, in the case of a client who is near death, additional precautions should be considered. First, “certifying” the check should eliminate the difficulty inasmuch as the gift becomes complete at the time of certification, thus qualifying it for the exclusion. Second, in the alternative, the check should be deposited as quickly as possible in order to increase the likelihood that it will clear before death. Third, as another alternative, if the donee were to take some action requested by the donor in exchange for the check, the gift becomes complete immediately without regard to the date it clears the bank (provided that the donee’s action would constitute sufficient consideration as a matter of state law, even if it would not constitute consideration for transfer tax purposes). Finally, as a last alternative, if the donor were to make the gift by delivering stock or some other asset, rather than issuing a check, the gift would be complete upon delivery.

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Website: www.unionplanters.com
Type of Operation: TRAD
Offers Private Banking Services: Yes
Assets: (Total Trust Entity)
Total Discretionary: $43,075,000
Total Nondiscretionary: $23,706,000
Total Trust Assets: $66,781,000
Trust Dept. Personnel:
Craig Boone: SVP/TO
Donna Winters: Ops Coord. T03s
Steve Hill: VP, PersTr
Tanya Elington: AVP, EmpO

Union Planters Trust & Investment Group
300 S Church St (72401)
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Offers Private Banking Services: Yes
Trust Dept. Personnel:
Craig Boone

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Fax: 501-379-7960
HQ Location: Rogers, AR
Email: hthruman@arvest.com
Website: www.arvest.com/trust
Type of Operation: TRAD
Offers Private Banking Services: No
Trust Dept. Personnel:
Rebecca L. Fletcher: VP, PersTr
William A. Smith: SVP, HR/TO

Metropolitan National Bank
PO Box 8010 (72203)
Tel: 501-377-7650
Fax: 501-377-7688
Website: www.metbank.com
Type of Operation: COMM
Offers Private Banking Services: Yes
Assets: (Total Trust Entity)
Total Discretionary: $37,500,000
Total Nondiscretionary: $25,000,000
Total Trust Assets: $60,000,000
Trust Dept. Personnel:
Anna Henderson: AVP, CorpTr
Bill Harms: VP, EmpO
Connie Cove: TA, TrAdmin
Debra Hook: AVP, PersTr
Michael McRae: SVP, HR/TO

Pulaski Bank & Trust
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Tel: 501-661-7761; 800-291-9904
Fax: 501-661-7731
Website: www.pulaskibank.com
Type of Operation: COMM
Offers Private Banking Services: No
Assets: (Total Trust Entity)
Total Discretionary: $3,222,000
Total Nondiscretionary: $0
Total Trust Assets: $3,222,000
Trust Dept. Personnel:
Sandra Brandt, Kim: AVP, CorpTr

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Tel: 870-541-1000; 800-442-0888
Fax: 870-541-1246
Website: www.mountainsfirst.com
Type of Operation: EST/INV
Offers Private Banking Services: No
Assets: (Total Trust Entity)
Total Discretionary: $749,389,000
Total Nondiscretionary: $192,625,000
Total Trust Assets: $942,014,000
Trust Dept. Personnel:
Cathy Holder: VP/SVP
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David Daniel: VP/TO
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Email: lwolstenholm@arvest.com
Website: www.arvest.com/trust
Type of Operation: TRAD
Offers Private Banking Services: No
Trust Dept. Personnel:
Ann Nicholas: TO, PersTr
Fred W. Lockwood: SVP, EmpO
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Lisa Harris: VP, PersTr
Melissa Haynold: TO, PersTr
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