Medicaid and Real Estate Preservation Strategies

Income, Gift & Estate Tax Consequences of Property Transfers
With Retained Life Estates and Grantor Trusts

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by

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I. WHAT IS A LIFE ESTATE?

A life estate is not a trust according to the MassHealth Regulations.

Life Estate –a life estate is established when all of the remainder legal interest in a property is transferred to another, while the legal interest for life rights to use, occupy or obtain income from the property is retained.

Trust – a legal device satisfying the requirements of state law that places the legal control of property or funds with a trustee. It also includes, but is not limited to, any legal instrument, device, or arrangement that is similar to a trust, including transfers of property by a grantor to an individual or a legal entity with fiduciary obligations so that the property is held, managed, or administered for the benefit of the grantor or others. Such arrangements include, but are not limited to, escrow accounts, pension funds, and similar devices as managed by an individual or entity with fiduciary obligations.

Trustee – any individual or legal entity that holds or manages a trust. See 130 CMR 515.001 (Definitions).

Liability of Remainderman – A remainderman owes no duty of care to the life tenant's tenants, absent a duty voluntarily assumed by the remainderman. *Delprete, Adm. v. Ferrante, et al* LW No. 16-106 King.J Suffolk No. 90-2152B

II. INCOME ONLY DISCRETIONARY TRUST

The dispositive provisions of a typical income only discretionary trust might be as follows:

Irrevocability

The Donor expressly waives any and all right which **he/she** may have, by operation of law or otherwise, to revoke, alter, amend or otherwise change this Indenture of Trust or any of the provisions hereof.

Payments During Donor's Life

.01 During the lifetime of the Donor, the Trustee shall hold and administer the Trust property as follows.

.02 The Trustee shall pay to the Donor so much of the net income, if any, as the Trustee deems advisable in the Trustee's sole and absolute discretion.

.03 The Trustee shall have no power to make any distributions of principal to or for the benefit of the Donor.

.04 The Trustee shall pay such amounts of principal as the Trustee, in its sole and absolute discretion, shall determine to or for the benefit of the members of the class consisting of the issue of the Donor living from time to time.

.05 Notwithstanding the foregoing, the Donor reserves a limited or special power of appointment, exercisable during **his/her** lifetime by written instrument delivered to the Trustee, to appoint the remaining principal and any undistributed income of the Trust, outright or upon trusts, powers of appointments, conditions or limitations, to such person or persons (whether in equal or unequal shares) among the members of the class consisting of the Donor's issue of all generations or charitable organizations other than governmental entities, but no such power or payment shall be used to discharge a legal obligation of the Donor.

Payments After Donor's Death

.01 Upon the death of the Donor, the remaining principal and any undistributed income of the Trust shall be paid over to such person or persons (whether in equal or unequal shares and whether in trust or otherwise) among the class consisting of the Donor's issue of all generations, but excluding the Donor's estate, creditors of the Donor or creditors of the Donor's estate, as the Donor shall appoint by a will specifically referring to this power. Any portion or all of such property not fully and effectually so appointed shall be distributed as hereinafter provided.

.02 Any property not so appointed shall be divided and allocated into as many equal shares as there are children of the Donor then living and children of the Donor then deceased leaving issue then living.

.03 In the case of a share allocated to a then living child of the Donor, said share shall be paid over and distributed to such child, outright and free of trusts.

.04 In the case of a share allocated to issue of a deceased child of the Donor, the Trustee shall pay or apply so much of the income or principal as it, in its sole discretion, shall determine to such issue for their health, education, support and maintenance, until there is no issue of such deceased child living who is under the age of twenty-five (25) years, and the Trustee shall distribute the then remaining balance of said share to said issue, by right of representation, or, if there are no such issue then living, to the then living issue of the Donor, provided that if any such issue are among the beneficiaries of any share then being held by the Trustee under this instrument, each such issue's portion of such distribution shall be added to and held by the Trustee as part of the share of which such issue is a beneficiary

III. THE ESTATE, GIFT & INCOME TAX RULES

1. Federal Exemption Amounts for deaths before January 1, 2003 and after December 31, 2010

The Taxpayer Relief Act of 1997, signed on August 5, 1997, set forth the following applicable exclusion amounts:

In the case of estates of decedents dying and gifts made during:	The applicable exclusion amount is:
1998	$ 625,000
1999	$ 650,000
2000	$ 675,000
2001	$ 675,000
2002	$ 700,000
2003	$ 700,000
2004	$ 850,000
2005	$ 950,000
2006 or thereafter	$ 1,000,000

2. **Restoring Earnings to Lift Individuals and Empower Families Act of 2001 – Estate and Gift Taxes (the "2001 ACT")**

The following table shows the rate reductions and the exemption increases for the estate and gift taxes that will occur between 2002 and 2010:

Year	Estate Transfer Exempt Amount (Applicable Exclusion Amount) and GST Exemption	Lifetime Gift Exempt Amount	Highest and Gift Tax Rates
2002	$1 million	$1 million	50%*
2003	$1 million	$1 million	49%
2004	$1.5 million	$1 million	48%
2005	$1.5 million	$1 million	47%
2006	$2 million	$1 million	46%
2007	$2 million	$1 million	45%
2008	$2 million	$1 million	45%
2009	$3.5 million	$1 million	45%
2010	Tax repealed	$1 million	35% (gift tax)
2011	$1 million	$1 million	55%

*Reflecting repeal of the 5% surtax.

This is effective for estates of decedents dying and lifetime gifts made after 2001.

The lifetime gift tax exemption stayed at $1,000,000 per person/donor. This is in addition to the annual exclusion gift of $11,000 per year per donee.

This phased-in increasing exemption had the effect of reducing both federal and Massachusetts estate taxes because, beginning in 1997, the Massachusetts estate tax liability, also known as the "sponge tax," was determined by reference to the federal State Death Tax Credit. As a result, if a federal estate tax return was not required to be filed, no Massachusetts estate tax was due.

3. Massachusetts Sponge Tax System

Under the sponge tax system, the estate tax payable to a state with such a system would equal the amount of the maximum credit for state death taxes payable as reported on the decedent's federal estate tax return. A sponge tax system was implemented by the Commonwealth of Massachusetts for deaths occurring on or after December 31, 1996 to "soak up" tax dollars that would otherwise have been paid to the federal government.

The sponge tax, or State Death Tax Credit, is determined by multiplying the federal "adjusted taxable estate" by marginal tax rates ranging from .8 percent to 16 percent. The so-called "adjusted taxable estate" was the federal taxable estate reduced by $60,000. IRC Sect. 2011(b)(3).

For example, if a decedent died in 2005 with a taxable estate of $1.5 million and a federal exemption of $1,500,000, the State Death Tax Credit, and therefore the sponge tax due to Massachusetts, would be $64,400, computed as follows:

	Assets	Tax
Taxable Estate	$1,500,000	
Less: $60,000 per IRC §2011(b)(3)	(60,000)	
Adjusted Taxable Estate ("ATE")	$1,440,000	
Bracket from Table	(1,040,000)	$38,800
Excess of ATE over Bracket	$ 400,000 x 6.4%	25,600
		$64,400

4. The New Massachusetts Exemptions

The Massachusetts Act, by defining the tax due to be the "credit for state death taxes" computed under the Internal Revenue Code as in effect on Dec. 31, 2000, means that the lower exemptions of the TRA, and not the higher exemptions of the 2001 Act, must be used to determine the Massachusetts filing threshold. In effect, the Massachusetts Act de-couples the federal and Massachusetts estate tax systems.

The following table compares the filing thresholds:

Year	Mass. Exemption	Federal Exemption
2003	$700,000	$1 million
2004	$850,000	$1.5 million
2005	$950,000	$1.5 million

2006	$1 million	$2 million
2007	$1 million	$2 million
2008	$1 million	$2 million
2009	$1 million	$3.5 million
2010	$1 million	No Federal Estate Tax
2011	$1 million	$1 million

5. **<u>Massachusetts Lien Statute</u>**

The Massachusetts estate tax lien statute was amended for decedents dying on or after January 1, 1997, in recognition of the increasing exemptions under the TRA. G.L. c. 65C, §14.

As currently enacted, emphasizing that it was not amended as part of the Massachusetts Act, the statute provides as follows:

> "Unless the tax imposed by this Chapter is sooner paid in full, it shall be a lien for ten years from the date of death upon the Massachusetts gross estate of the decedent, except that such part of the Massachusetts gross estate, as is used for the payment of charges against the estate and expenses of its administration, allowed by the probate court having jurisdiction thereof, shall be divested of such lien. For dates of death on or after January 1, 1997, an affidavit of the executors subscribed to under the pains and penalties of perjury, recorded in the appropriate Registry of Deeds, and *stating that the gross estate of the decedent does not necessitate a federal estate tax filing, shall release the gross estate of the lien imposed by this section.* (emphasis added). M.G.L.c. 65C, § 14(a)

Additionally, M.G.L.c. 65C, § 6 provided:

> (a) The tax imposed by this Chapter shall be paid by the executor. The term "executor," wherever used in this Chapter, means the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified and acting within the Commonwealth, then any person in actual or constructive possession of any property of the decedent. The probate court may authorize an executor to sell so much of the property of the estate as will enable him to pay such tax in the same manner as it may authorize him to sell such property for the payment of debts.
>
> (b) No final account of an executor of any estate shall be allowed by the probate court unless and until the executor shall have filed in the probate court a certificate of the commissioner showing either that the amount of the tax has been paid, that payment thereof has been secured as provided in section ten, or that no tax is due. *For dates of death on or after January 1, 1997, said certificate of the commissioner shall not be required.* (emphasis added).

Through a Technical Information Release, the Massachusetts Department of Revenue has indicated that it will not accept a Massachusetts estate tax return if the gross estate of the decedent did not necessitate a federal estate tax filing. TIR 98-14.

As a result, the executor is unable to obtain a form M-792, the usual document recorded to release the Massachusetts estate tax lien if the gross estate did not necessitate a federal estate tax filing.

The DOR has acknowledged this issue and has provided some guidance. In Massachusetts Department of Revenue Directive 03-2 (hereinafter "DD-03-2"), the DOR has suggested that for estates of decedents dying on or after January 1, 2003, an affidavit of the executor subscribed to under the pains and penalties of perjury, recorded in the appropriate Registry of Deeds and stating that the gross estate of the decedent does not necessitate a Massachusetts estate tax filing shall release the gross estate of the lien imposed by M.G.L. c.65C, §14.

6. MCA Title Standard No. 24 for Massachusetts Estate Tax Liens

New MCA (now REBA) Title Standard No. 24 relating to Massachusetts estate tax liens provides as follows:

24.3 – Deaths on and after January 1, 2003

There is no Massachusetts estate tax lien if the decedent died on or after January 1, 2003 and the sum of (a) the decedent's federal taxable estate, and (b) adjusted taxable gifts (i.e., gifts in excess of the annual nontaxable gift exclusion amount) (the "Filing Threshold") was less than the amounts set forth below:

Year of Death	Filing Threshold
2003	$ 700,000
2004	$ 850,000
2005	$ 950,000
2006	$1,000,000

Land is free of the Massachusetts estate tax lien ten years after the date of death and sooner:

(1) when there is proof of payment of the amount shown by the Massachusetts estate tax closing letter provided (a) the land is reported in the probate inventory filed in the decedent's estate, or (b) in the case of non-probate property, there is properly documented evidence that the property was listed in the estate tax return; or

(2) when the Commissioner of Revenue issues a certificate of release or partial discharge of the lien; or

(3) upon the recording of an affidavit under the penalties of perjury stating that the decedent's estate does not necessitate the filing of a Massachusetts Estate Tax return based upon the amounts set forth in the table, above. See M.G.L. c.65C, §§ 14(a) and 6(a). See also MCA Form 32.

Comment: For deaths on or after January 1, 2003, the Massachusetts estate tax has been "decoupled" from the Federal Estate Tax and is instead tied to the provisions of the Internal

Revenue Code effective as of December 31, 2000. As a result of these changes, the threshold amounts for filing Massachusetts and federal estate tax returns will be different after January 1, 2003. Massachusetts estate tax returns are required when the federal gross estate, less allowable deductions, plus adjusted taxable gifts, exceeds the Filing Threshold set forth in the chart above.

As the gross estate includes life insurance, joint property, trust funds with non-probate property, the fact that the probate estate is small does not prove the assumption that there is no estate tax lien.

7. **Income Tax Rates**

A. Federal – Long Term Capital Gains.

For sales after May 5, 2003, the maximum tax rates applicable to long term capital gains is 15% but only 5% for individuals in the 10% or 15% bracket and 0% for individuals in the 5% bracket for tax years beginning after December 31, 2007.

If the asset sold is a collectible, the rate is 25% and the 25% rate applies to unrecaptured depreciation under IRC § 1250.

B. Federal – Ordinary Income

2004

Taxable Income				
Over	**But Not Over**	**Pay**	**% on Excess**	**Of the Amount Over**
$ 0	$ 7,150	$ 0	10%	$ 0
7,150	29,050	715.00	15%	7,150
29,050	70,350	4,000.00	25%	29,050
70,350	146,750	14,325.00	28%	70,350
146,750	319,100	35,717.00	33%	146,750
319,100		92,592.50	35%	319,100

C. Massachusetts

For sales on or after May 1, 2002, long term capital gains are taxed at 5%.

8.. **Long Term Gain Property**

The gain will be long term if the property was owned for more than 12 months. IRC § 1222(3). Additionally, inherited property acquired from a decedent will be deemed to have been held for more than 12 months even if it was sold within one year of the decedent's death. IRC § 1223(11).

9. **Holding Period**

A. General Rules

To determine the holding period, the beginning date is the day after the property was acquired and the date the property is sold is part of the holding period. Rev. Rul. 66-7. In a tax free exchange, the acquired property will have the same holding period as the property exchanged. IRC § 1223.

B. Gifted Property

The donee's holding period includes the holding period of the donor. IRC § 1223(2).

C. Inherited Property

Property acquired from a decedent is deemed to be held for more than 12 months (and therefore is long term capital gain property.) IRC § 1223(11).

10. **Basis of Property Received from a Decedent**

A. Present Law

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (gross proceeds realized) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Property received from a donor of a lifetime gift takes a carryover basis. IRC § 1015(a) "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. IRC § 1015(d) The basis of lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of gift thereby providing the donee with a "stepped down" basis. IRC § 1015(a)

Property passing from a decedent's estate generally takes a stepped up basis. IRC § 1014 "Stepped up basis" for estate tax purposes means that the basis of the property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is selected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and has the effect of eliminating the tax benefit from any

realized loss. No step up is permitted if the recipient had transferred the property to the decedent within one year of death. IRC § 1014(e).

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any state, U.S. possession or foreign country), generally is treated as having passed from the decedent, and thus is eligible for stepped up basis. The rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

B. 2001 Act – Carryover Basis

Once the estate tax is repealed in 2010, a modified carryover basis structure will be established. Under this structure, recipients of property transferred at death generally will acquire a basis in the property equal to the lesser of the:

- Decedent's basis in the property immediately before death, or

- Date-of-death value of the property.

The modified carry-over basis rules apply to "property acquired from a decedent" by bequest, devise, or inheritance, or by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that had been depreciated and would be subject to recapture if sold by the decedent, will be subject to recapture if sold by the heir. Additionally, this property had to be owned by the decedent at the time of death.

C. Types of Property to Which the Modified Carryover Basis Rules Apply

The modified carryover basis rules apply to property "acquired from the decedent." Property acquired from the decedent is:

(a) property acquired by bequest, devise, or inheritance, New Code § 1022(e)(1)

(b) property acquired by the decedent's estate from the decedent, New Code § 1022(e)(1)

(c) property transferred by the decedent during his or her lifetime to a qualified revocable trust as defined in IRC § 645(b)(1), New Code § 1022(e)(2)(A)

(d) property transferred by the decedent during his lifetime in trust with the right reserved to the decedent at all times before his death to make any change to the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust New Code § 1022(e)(2)(B),

(e) any other property acquired from a decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship, life estates or as tenants by the entireties), New Code § 1022(e)(3)

(f) the surviving spouse's one-half share of certain community property owned by the decedent and the surviving spouse as community property.

D. Aggregate Increase in Basis

Under the 2001 ACT, each decedent's estate generally is permitted to increase (i.e., step up) the basis of assets transferred by up to a total of $1,300,000. Additionally, basis may be further increased by any unused capital losses, net operating losses, and certain built-in losses of the decedent. An additional $3 million of basis increase is available for property transferred to a surviving spouse for a total of $4,300,000. The executor chooses the property that will receive these basis increases. However, in no event can the basis of property be adjusted above its date-of-death value.

Non-residents who are not U.S. citizens will be allowed to increase the basis of property by up to $60,000. The $60,000, $1,300,000 and $3,000,000 amounts are to be adjusted for inflation occurring after 2010.

E. Property acquired by Surviving Spouse

The special $3,000,000 spousal property basis increase applies to so-called "qualified spousal property." The term "qualified spousal property" means (A) an outright transfer of property, and (B) qualified terminable interest property. New Code § 1022(c)(1)(2) and New Code § 1022(c)(1)(3).

F. Special Rule Relating to Grantor Trusts

Any transfer of property in trust will be treated as a taxable gift under IRC § 2503 unless the trust is treated as wholly owned by the donor or the donor's spouse. IRC § 2511(c)

G. Rules Allocable to Basis Increase

The basis increase will be allocated on an asset-by-asset basis (for example, basis increase can be allocated to a share of stock or a block of stock), however, in no case can the basis of an asset be adjusted above its fair market value. If the amount of basis increase is less than the fair market value of the asset whose basis are eligible to be increased under these rules, the executor will determine which assets and to what extent each asset receives a basis increase.

11. **Massachusetts Basis**

The basis for determining adjusted Massachusetts gain is set forth in M.G.L. c.62, §6F. Generally, the basis will be federal basis for any differences in allowable depreciations. As to property "acquired from a decedent" within the meaning of IRC § 1041(b), the initial basis shall be determined under IRC § 1014. IRC § 1014(a) provides that the basis acquired from a decedent is the fair market value of the property on the date of the decedent's death.

12. **Gifting Rules**

A. General Rules

IRC § 2501(a) imposes a tax on lifetime gifts by a taxpayer. The amount of the tax is determined by using the estate tax rates under IRC § 2001(c). The tax, if any, is paid by the donor. IRC § 2502(c). Life time gifts up to the exemption amount of $1,000,000 do not give rise to a tax liability because the tax computed on the first $1,000,000 of gifts is offset by the applicable credit amount.

B. Exclusions

In the case of gifts (other than gifts of a "future interest" in property) made to any person during a calendar year, the first $11,000 of such gifts to such person will be excluded from so-called taxable gifts. IRC § 2503(b). Transfers on behalf of a person made for tuition for the education and training of any individual or to any person who provides individual care are also excluded from the definition of "taxable gift." IRC § 2503(e)

C. Future Interests

"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. An unrestricted right to the immediate use, possession, or enjoyment of property or income from property (such as a life estate or term certain) is a present interest in property. Regs. 25.2503-3(a), (b).

Planning Note: The gift of a remainder interest is a future interest since under state law, a remainderman does not have a right to partition. G.L.c. 241, §1.

D. Incomplete Gifts:

Regs. 25.2511-2(b) provides: As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But, if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. For example, if a donor

transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift. However, if the exercise of the trustee's power in favor of the grantor is limited by a fixed or ascertainable standard (see paragraph (g)(2) of § 25.2511-1), enforceable by or on behalf of the grantor, then the gift is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor.

A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, if an estate for life is transferred but, by an exercise of a power, the estate may be terminated or cut down by the donor to one of less value, and without restriction upon the extent to which the estate may be so cut down, the transfer constitutes an incomplete gift. If, in this example, the power was confined to the right to cut down the estate for life to one for a term of five years, the certainty of an estate for not less than that term results in a gift to that extent complete.

A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.

A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having a substantial adverse interest in the disposition of the transferred property or income. Regs. 25.2511-2(b)(c).

Planning Note: The gift of a remainder interest to children is a completed gift but a gift into an income only trust for the benefit of the children where to the donor has retained either an inter vivos or testamentary limited power of appointment not limited by an ascertainable standard is an incomplete gift.

13. How to Compute the Value of a Gift of a Partial Interest in Property

A. Life Estates and Remainder Interests

A transfer of a partial interest in property, such as a remainder interest in the case of a deed with a reserved life estate, must be valued using actuarial tables provided by the IRS. These tables have built-in mortality assumptions and interest rate assumptions. The assumed rate of interest changes monthly with the relevant rates being the "applicable interest rate equal to 120% of the federal mid-term rate under IRC § 1274(c)(1) for the month in which the valuation occurs." IRC § 7520(a)(3). This is the so-called "7520 rate."

Planning Note: For February, 2005, the IRC 7520 rate is 4.6%.

Examples

In this case, if the property was transferred by the taxpayer (age 66) with a single life estate reserved, the gift valued would be $204,548.00.

Transfer Date:	2/2005
§ 7520 Rate:	4.6%
Calculation Type:	Life
Principal:	$400,000
Lives:	1
Ages:	66

	Life Estate	Remainder
Factor:	0.48863	0.51137
Value:	$195,452.00	$204,548.00

If the transfer was made by the younger spouse at age 62, the gift would be $183,208.00.

Transfer Date:	2/2005
§ 7520 Rate:	4.6%
Calculation Type:	Life
Principal:	$400,000
Lives:	1
Ages:	62

	Life Estate	Remainder
Factor:	0.54198	0.45802
Value:	$216,792.00	$183,208.00

If the transfer was made by either spouse but the life estate was reserved until the death of the survivor, the gift would be $148,523.00.

Transfer Date:	2/2005	
§ 7520 Rate:	4.6%	
Calculation Type:	Life	
Principal:	$400,000	
Lives:	1	
Ages:	66, 62	
	Life Estate	Remainder
Factor:	0.62869	0.37131
Value:	$251,476.00	$148,524.00

B. Partial Interests in Real Estate

A transfer of a partial interest in real estate, as a tenant in common for example, is valued by applying a discount to the pro-rata fair market value of the property transferred. Discounts of up to 25% are allowed owing to the fact that a willing buyer will not pay a full pro-rata share of the property's value but the owner can force a sale through a partition to partition and realize some value. The 25% discount is based on the estimated cost of realizing rate through a state law petition to partition process. PLR 9336002, *Estate of Barge v. IRS*, 73 TCM 2615 (1997) (25% discount allowed). See also *Williams v. Commissioner*, T.C. Memo 1998-59 (44% discount allowed). *Prosptra v. United States*, 680 F.2d 1248 (9th Cir. 1982) (15% discount), *Estate of Campanari v. Commissioner*, 5 T.C. 488 (1945) (12.5% discount), *Estate of Henry v. Commissioner*, 4 T.C. 423 (1944) (10% discount), *Estate of Youle v. Commissioner*, 56 T.C.M. CCH 1594 (1989) (12.5% discount). The government's argument that the availability of a discount should depend upon the relationship of the donor and donee was rejected.

In the estate tax context, in *Estate of Young*, 110 T.C. 297 (1998), the Tax Court denied both a fractional interest discount and a lack of marketability discount for the value of one-half of joint property includible under IRC § 2040. The Court distinguished joint tenancies from tenancies in common. In this case, the spouse was a non-citizen so that IRC § 2040(a) and not IRC § 2040(b) applied. Under IRC 2040(a), the entire value of the property is includible. This same result was reached in *Estate of Fratini v. Commissioner*, T.C.Memo. 1998-308.

If the property is transferred by using a change in a schedule of beneficiaries in a realty trust, a larger discount may be allowable to the extent the beneficiaries are treated as partners. See *Medalion Realty Trust*, 150 B.R. 495 (D. Mass. 1990) (beneficiaries of a nominee trust bear the relationship of parties in a general partnership); *Anastos v. Sable*, SJC No. 09252 – 12/22/04 (a 40% discount was appropriate in valuing a partner's interest in a general partnership).

14. **IRC § 2702**

A special gift tax rule applies to transfers of property with a retained interest. IRC § 2702 provides that, for purposes of determining the value of the property transferred with a retained interest (such as a life estate), the value of the retained interest (the life estate) will be zero unless the retained interest is a "qualified interest." In general, a life interest is not a "qualified interest" but fortunately, IRC § 2702 does not apply "if such transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust." IRC § 2702(a)(3)(ii)

Planning Note: In this case, both residential properties are excluded from the adverse gift tax consequences of IRC § 2702.

15. **Part Sale – Part Gift**

The regulations provide that, if a transfer of property is in part a sale and in part a gift, the transferor realizes gain for income tax purposes to the extent that the amount realized exceeds the transferor's adjusted basis in the property, but no loss is realized by the transferor if the amount realized is less than the transferor's adjusted basis. Regs. 1.1001-1(e). The basis of the property in the hands of the part-gift, part-sale transferee generally is the sum of:

(1) the greater of:
(a) the amount paid by the transferee for the property, or
(b) the transferor's adjusted basis for the property at the time of the transfer,
plus

(2) the § 1015(d) increase in basis for gift tax paid.

Example: J transfers property with an adjusted basis of $20,000 and a fair market value of $90,000 to J's child, B, for $60,000. The transfer is deemed a sale to the extent of the consideration received by J ($60,000) and as a gift to the extent the fair market value of the property exceeds the consideration paid ($90,000 - $60,000 = $30,000). Because the amount paid by B for the property ($60,000) exceeds J's adjusted basis in the property ($20,000), B's basis in the property is $60,000. If B had paid $15,000 for the property, B's basis would be the same as J's adjusted basis in the property ($20,000). Regs. 1.1001-1(e); 1.1015-5(a)(2).

The basis of the property in the hands of the transferee for purposes of determining loss, however, may not be greater than the fair market value of the property at the time of the transfer. Regs. 1.1015-5-5(a)

Example: J transfers property with an adjusted basis of $75,000 and a fair market value of $60,000 to B for $50,000. J has made a gift to B of $10,000, the excess of $60,000, the fair market value of the property, over $50,000, the amount realized by J. J does not realize a loss for income tax purposes even though the $50,000 amount realized is less than J's adjusted basis of $75,000. B's basis for purposes of determining gain is $75,000 (the

carryover basis from J), and B's basis for determining loss is $60,000 (the fair market value on the date of the gift).

If the gifted property is subject to a mortgage or otherwise is encumbered by a liability of the donor, and the donee assumes, or take the property subject to, the liability, the transaction is treated as a part-gift, part-sale. A gift of property subject to a liability is considered to be a realizing event to the extent the transferor's liabilities, and the transferor realizes gain to the extent the liability exceeds the transferor's basis in the property. *Crane v. Commissioner*, 331 U.S. 1 (1947) (recourse note deemed sale price); *Commissioner v. Tufts*, 461 U.S. 300 (1983) (non-recourse note equals deemed sale price).

Planning Note: If the mortgage exceeds basis, consider using a grantor trust as the donee since no gain is recognized on a transaction between a grantor and grantor trust. Rev. Rul. 85-13. If the property is subject to a mortgage, the debt reduces the value of the gift. PLR 9249014. As principal payments are made, there is an additional gift equal to the actuarially determined value of the remainder's interest in the payment. The payment of interest should not be a gift since interest is a charge to the life interest under state law.

16. Sale of real Estate Subject to Life Interest and Remainder Interest

If the property is sold, the gain (and proceeds) will be split between the life interest and the remainderman using the actuarial tables and IRC § 7520 rate applied for the month in which the sale occurs. Basis also would be allocated at the time of the sale using the 7520 rate. Rev. Rul. 71-122. The gain allocated to the life interest is eligible for exclusion under IRC § 121 but the gain allocated to remainder interest is not unless the remainderman is a grantor trust. Rev. Rul. 66-159; Rev. Rul. 85-45; PLR 9118017.

17. Exclusion From Gain on Sale of Principal Residence

The one time exemption of $125,000 applicable to home sellers age 55 and older, and the 24 month rollover provisions applicable to the sale of the taxpayer's principal residence have been repealed effective for sales which occur on or after May 7, 1997. The new rules are quite simple, as follows.

The property owner (of any age) can exclude up to $250,000 of gain attributable to the sale of the taxpayer's principal residence. This amount is increased to $500,000 for joint filers in certain situations. To be eligible, the taxpayer must have owned and used the property as his or her principal residence for at least two of the last five years before the sale. The ability to exclude the gain is available only once every two years.

The principal residence can include a single family structure, trailer, mobile home, house boat, condominium, cooperative duplex or row house and will include any other boat if the boat contains facilities for cooking, sleeping and sanitation (as long as the facility is the taxpayer's principal residence).

18. Grantor Trust Rules

A. IRC § 671 - Trust income, deductions and credits attributable to grantors and others as substantial owners.

IRC § 671 provides that where the grantor or another person is be treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or the other person, those items of income, deductions and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.

B. What is any portion of a trust?

The answer to this question involves an understanding of traditional trust accounting income. Traditional trust accounting income rules provide that items of capital gain would be allocated to a corpus while traditional items of income such as interest, dividends and tax exempt interest would be allocated to income for trust accounting income purposes. The result is that if the grantor is considered the owner of the income interest only, the grantor will be taxed only on the ordinary income of the trust. In the field of Medicaid planning, it would be desirable to have the grantor treated as the owner of income and principal so that capital gains would be allocated to the grantor as well as ordinary income.

C. IRC § 672 - Definitions and rules/adverse party.

The concept and identity of an "adverse party" is of critical importance in planning with grantor trusts because some of the rules giving rise to a grantor trust require that the power be held by the grantor or a "non-adverse party". (IRC § 674 - power to control beneficial enjoyment; IRC § 677 - income for benefit of grantor.)

D. What is an "adverse party"?

IRC § 672(a) provides that an "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust. IRC § 672(b) provides that a "nonadverse party" means any person who is <u>not</u> an adverse party.

E. Income only discretionary trust.

The income only discretionary trust with either an intervivos or testamentary power of appointment will be a grantor trust as to both income and principal under IRC § 674.

F. IRC § 674 (Power to affect beneficial enjoyment)

Under IRC § 674, the grantor shall be treated as the owner of any portion of a trust in which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of

disposition exercisable either by the grantor or a so-called nonadverse party, or both, without the approval or consent of any adverse party.

G. IRC § 675 (Power of Administration)

The grantor also will be treated as the owner of any portion of a trust in respect of which there is a so-called power of administration exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. This power should not be used in a Medicaid plan. An example of this power would be a power to reacquire the trust corpus by substituting other property of an equivalent value. IRC § 675(4)(C).

H. IRC § 676 (Power of revocation)

A revocable trust is a grantor trust under IRC § 676(a), but this should not be used in a Medicaid plan.

19. Other Benefits of Grantor Trust Status

A. S Corporations.

A grantor trust is an eligible S corporation shareholder provided the grantor is the deemed owner of both income and principal of the IDIT. IRC § 1361(c)(2)(A)(i).

B. Grantor's Home.

(1) If the property transferred to the grantor trust was the grantor's home, the sale of the home by the trust would be eligible for the new $250,000 capital gain tax exclusion ($500,000 in the case of a married couple filing jointly). See Rev. Rul. 66-159 and Rev. Rul. 85-45.

(2) The payment of rent by the grantor to the grantor trust is non-taxable since transfers between a grantor and a grantor trust are ignored for income tax purposes. Rev. Rul. 85-13.

(3) If the property in the IDIT has appreciated in value but has a low tax basis, the grantor may repurchase the property from the trust for cash just prior to death to obtain a step-up in basis. (Under new Regulations governing a Qualified Personal Residence Trust ("QPRT"), this benefit was thought to be too good and is now limited to non-QPRT trusts.)

(4) The transfer of an installment note to a grantor trust is not a disposition of the note triggering an acceleration of any deferred gain. Rev. Rul. 74-613.

C. Selling Assets to a Defective Grantor Trust is Income Tax Free.

One of the most popular current estate planning techniques involves the sale of assets tax free to a grantor trust. Rev. Rul. 85-13; PLR 9535026; PLR 9519029. In such a case, the grantor trust pays for the property with a promissory note which has the effect of "freezing" the grantor's estate while shifting all future appreciation attributable to the property sold to the grantor trust for the younger generations free of estate and generation skipping taxes. The promissory note must bear interest at the appropriate applicable federal rate ("AFR") but this rate is minimal. According to *Frazee v. Commissioner*, 98 T.C. 37 (1992) the following rates would apply:

(1) Use short term AFR if maturity is 3 years or less.

(2) Use mid-term AFR if maturity is more than 3 years but not more than 9 years.

(3) Use long term AFR if maturity is more than 9 years.

20. **Gift Tax Filing Regulations**

A. Federal

A federal gift tax return (Form 709) must be filed for any calendar year (due 4/15 of the year following the year in which the gifts are made), unless the gift is less than the annual exclusion amount of $11,000 per year per donee (IRC § 2503(b)) was for education or medical expenses (IRC § 2503(e)), or eligible for either a charitable deduction under IRC § 2522 or the gift tax marital deduction under IRC § 2523. IRC § 6019.

A gift tax return must be filed if the gift is not a present interest, regardless of amount. If spouses transfer property held by them as either joint tenants or tenants by the entirety, both spouses must file a gift tax return.

Spouses may elect to so-called "gift split." This means if one spouse makes a transfer, the non-donor spouse may consent to the gift treated as being made on behalf of both spouses. As to filing, only the donor is required to file the return with the non-donor spouse's consent by signing the return, unless the total gift by the donor to any one donee exceeds twice the amount of the annual exclusion, and all gifts are gifts of a present interest. Regs. 25.2513-1(c).

A gift tax return must be filed even if the gift is incomplete:

> "If a donor contends that his retained power over property renders the gift incomplete (see § 25.2511-2) and hence not subject to tax as of the calendar year of the initial transfer, the transaction should be disclosed in the return for the calendar quarter or calendar year of the initial transfer and evidence showing all relevant facts, including a copy of the instrument of transfer, shall be submitted with the return. The instructions printed on the return should be carefully followed. A certified or verified copy of each document required by the instructions printed on

the return form shall be filed with the return. Any additional documents the donor may desire to submit may be submitted with the return. Regs. 25.2511-3(a)."

B. Massachusetts Rules

There is no filing requirements for Massachusetts but the "taxable gift" (meaning the amount of the transfer in excess of the annual exclusion gift) will reduce the Massachusetts estate tax filing threshold.

21. Estate Tax Rules

A. Property subject to a life estate will be includible in the decedent's gross estate under IRC § 2036(a)(1) at the fair market value on the date of the decedent's death. Additionally, property in a trust in which the decedent had retained the power, as trustee or otherwise, to affect the beneficial enjoyment will be includible at fair market value on the date of death under IRC § 2036(a)(2).

B. Section 2036 Entity Transfers With Retained Life Estates and retained power to affect beneficial enjoyment. Section 2036 provides as follows:

"(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."

C. If spouses who owns property as tenants by the entirety transfers property together, they each will be deemed to have retained a life estate in one-half of the property. *Glaser v. Commissioner*, 306 F.2d 57-61 (7th Cir. 1962); *Sullivan's Estate v. Commissioner*, 175 F.2d 657, 659 (9th Cir. 1999).

22. **Special Rules**

A. Implied retained life estates without written agreements

A unique planning opportunity may exist in the case residential real estate. With growing concern over the continued attack on such Medicaid planning, planners may wish to utilize the principles in the Estate of Guynn, 437 F.2d 1148 (4th Cir. 1971). See also Rev. Rul. 70-155, 1979-1 C.B. 189. Generally, where the donor/decedent and the donee are husband and wife, the continued occupancy by the donor does not imply an agreement as to retain an interest in the property. However, when the donor and the donee are other than a husband

and wife, such as a transfer of a home from a single parent to a child, then the IRS has asserted that there is an implied agreement as to retained enjoyment by the transferors. This rule would apply even though there was no legal life estate or written documents concerning the arrangement. The benefit here is that for estate tax purposes, the transferee may obtain a stepped up basis while at the same time the asset clearly is placed beyond the reach of Medicaid creditors under existing law.

In Estate of Maxwell, 98 T.C. 39 (1992), the Tax Court ruled that the value of the decedent's former home had to be included in the decedent's estate even though the decedent "sold" the property to a child for $270,000; required payments of interest only at 9% per year (no principal was required); the decedent's will forgave the rule at death and the decedent canceled $20,000 of the note each year. The problem was that the decedent did not move out of the house and the Court found an implied agreement to use and occupy the home under IRC § 2036(a).

In *Estate of Powell v. Commissioner*, 63 T.C.M. 3192 (1992), the decedent transferred approximately 60% of his ownership interest in his principal residence to his children and their relatives. At the time of his death, the decedent owned approximately 40%. The decedent continued to live in the home until he was forced to move because of his physical condition. The decedent paid all expenses including real estate taxes, maintenance and upkeep. The Service argued that the decedent retained a life estate under IRC § 2036. The tax court disagreed finding that his continued occupation of the residence was consistent with his ownership as a tenant in common with his children. Earlier cases have ruled that such an arrangement was in effect a transfer with a retained life estate and therefore the full value of the property will be includible in the decedent's estate under IRC § 2036(a)(1). See also *Estate of Wineman*, 79 TCM 2189 (2000) (Decedent gifted 24 more than 20 years before death held not includible.)

B. Consider the benefits of Gallenstein.

Real estate in which the decedent owns an interest will be includible in the estate at fair market value. At death, all assets must be reported at fair market value without regard to historical cost or other basis. In the case of jointly owned real estate by persons other than spouses, 100% of the value will be includible in the estate of the decedent unless an affidavit of contribution is filed and accepted by the taxing authorities. For example, if two partners own real estate jointly, 100% of the value will be includible with a deduction equal to 50% based on the affidavit of contribution by the surviving co-owner filed with the estate tax return.

There is an exception to this rule in the case of jointly held property owned by spouses. Both Massachusetts and the IRS include only one half of the fair market value of such property jointly owned. IRC §2040(b) Note, however, in *Gallenstein v. United States*, 91-2 U.S.T.C. ¶60,088 (E.D. Kentucky 1991), aff'd 975 F.2d 286 (6th Cir. 1992), the 6th Circuit Court of Appeals ruled that property acquired as joint tenants before 1977 was eligible for treatment under the pre-1977 jointly held property rules. As such, the contributing owner was required to include the full value of the assets in the estate rather than under current law

where one-half of the value is included regardless of which spouse contributed the consideration. This provided the taxpayer with a full §1014 basis step-up while qualify for the unlimited marital deduction. IRC §2040(b) had been amended in 1981 to require inclusion of 50% on the death of the first qualified joint tenant to die. This case provides a significant planning opportunity to obtain a full step-up in basis with no estate tax costs.

Apparently, there is no need to amend the estate tax return in order to achieve the favorable results of *Gallenstein*. In *Patten*, 1996-1 USTC ¶60,231 (DC Va. 1996), and *Anderson*, 96-2 USTC ¶60,235 (DC MD 1996), the decedents and spouse had owned property as tenants by the entirety acquired before 1977. The husband died in 1989, at which time the wife became the sole owner of the property. At that time, the value of the property was $500,000, of which 50% was included in the decedent's spouse's gross estate.

In 1990, the decedent sold the real estate using an adjusted basis $256,982 based on one-half of the fair market value which had been included in her husband's estate. In 1994, after the decedent's death, the administratrix filed an amended income tax return that increased the basis of $500,000. The Court held for the taxpayer stating that for tenancies created before 1977, IRC §2040 included the entire value of the joint property in the deceased joint tenant's estate except to the extent the surviving joint tenant furnished consideration for the property.

For Massachusetts income tax purposes, the same rules will apply as to property acquired from a decedent who died on or after January 1, 1997. Prior to this date, the survivor would only have obtained a partial step-up in basis. *Treat v. Commissioner*, 52 Mass. App.208 (2001) (decedent died in 1993).