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PLANNING FOR CLIENTS WITH SHORTENED LIFE EXPECTANCIES

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BIOGRAPHICAL INFORMATION

MARVIN BLUM is the founder of THE BLUM FIRM, P.C. The firm, comprised of ten attorneys, specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning.

Blum, an attorney and certified public accountant, is Board Certified in Estate Planning and Probate Law and is a Fellow of the American College of Trust and Estate Counsel. He received his undergraduate degree in accounting at The University of Texas at Austin where he was Valedictorian of his graduating class and was named Ernst & Ernst Outstanding Student in Accounting. Blum received his law degree from The University of Texas School of Law where he graduated second in his class and was named the Prentice-Hall Outstanding Student in Taxation. Blum is a frequent speaker and author on estate planning and tax topics, and served for sixteen years on the faculty of the Texas School of Trust Banking. He is now in his twenty-seventh year as Treasurer of the Fort Worth Symphony and served for five years as President of the Board of Trustees of Trinity Valley School. Blum also serves as Chairman of the Fort Worth region of the National Conference for Community and Justice and on the board of the Van Cliburn Foundation. He and his wife, Laurie, are the parents of Adam, an investment analyst with the New York office of Goldman Sachs, and Elizabeth, a junior at New York University.

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TAX PLANNING FOR CLIENTS WITH SHORTENED LIFE EXPECTANCIES

by Marvin E. Blum

I. SALE OF ASSETS IN EXCHANGE FOR PRIVATE ANNUITY

A. GENERAL DESCRIPTION

This technique is particularly useful when dealing with clients who have marginal health, and therefore are not expected to live to their full actuarial life expectancy, but who still have a greater than 50% chance of living more than one year. In this transaction, the seller sells assets to the buyer in exchange for the buyer's promise to provide a stream of payments to the seller which will terminate upon the seller's death.

B. EXAMPLES

Assume Mom has $5 million in investment assets. Her basis in these assets is $3 million. Mom is 75 and has just been diagnosed with cancer. Her chances of recovery are poor, but she has a greater than 50% chance of living more than one year. It is possible that she will not live more than 2 to 3 more years.

Example 1: Mom decides to sell the $5 million in assets, in exchange for a private annuity, to a trust benefitting her children. The annuity payments will be made annually at the end of each year. Mom's health unexpectedly declines 6 months after she sells her assets, and she dies before she receives the first annuity payment.

Example 2: Assume the same facts as in Example 1, but that Mom's investment assets consist solely of a limited partnership interest in a Limited Partnership (the "LP") that owns various investment assets. Assume also that the LP has never made a Section 754 election.

Example 3: Assume that Mom lives 2 years after being diagnosed with cancer, and

receives 2 annuity payments prior to her death.

Example 4: Assume the same facts as in Example 3, except that the purchaser is a grantor trust with respect to Mom.

In the examples above, as long as Mom has a greater than 50% chance of living more than one year, then the IRS mortality tables and the § 7520 rate in effect at the time of the sale can be used to compute the annual payment required by the annuity. Treas. Reg. § 1.7520-3(b)(3). (Death is presumed to not be "clearly imminent" if the seller lives for at least 18 months after the sale, unless there is clear and convincing evidence to the contrary.)

Here, Mom has a greater than 50% chance of living more than one year. Therefore, the present value of the annuity payments can be computed in accordance with § 7520 and the tables provided thereunder. Using the current § 7520 rate of 6.2%, the IRS annuity tables provide that the present value of a $699,496 annual annuity is equal to $5 million. Therefore, if Mom sells a $5 million asset and receives payments of $699,496 per year for the rest of her life, she has received full and adequate consideration and there should be no gift.

C. TRANSFER TAX CONSEQUENCES

Because Mom satisfies the life expectancy requirements of §7520 and the present value of the annuity payments equals the value of the assets being sold, there should be no taxable gift upon the sale. Furthermore, since the annuity payments terminate upon Mom's death, the annuity has no value for purposes of determining her gross estate. § 2039.

1. Consequences under Examples 1 and 2

In Examples 1 and 2, when Mom dies, none of the $5 million in assets is includable in her estate. Therefore, Mom's estate pays no estate taxes, and she has transferred $5 million in assets estate and gift tax free.

2. Consequences under Examples 3 and 4

In Examples 3 and 4, when Mom dies, the two annuity payments will be included in her estate to the extent that they have not been spent. Therefore, they will be subject to estate taxes to the extent they cause the value of Mom's estate to exceed the applicable estate tax exclusion amount.

D. INCOME TAX CONSEQUENCES

To Seller: If the annuity is unsecured, the seller will recognize no gain or loss in the year of sale. From the seller's perspective, each annuity payment will be stratified. A portion will be considered return of capital, a portion will be capital gain or loss, and a portion will be ordinary income.

To Purchaser: The purchaser's income tax basis in the property purchased will be equal to the total amount of annuity payments actually made.

1. Consequences under Example 1

In Example 1, Mom dies before receiving any annuity payments. As a result, she has no income tax consequences from the sale. The trust that purchased the assets receives a basis of zero in the assets because it never made any annuity payments. If the purchaser subsequently sells one of the purchased assets, the purchaser would pay capital gains tax on the entire amount of the purchase. Therefore, if the assets are sold for $5 million, the purchaser would pay capital gains tax of $750,000 ($5 million x 15%).

2. Consequences under Example 3

In Example 3, Mom will receive two annuity payments of $699,496 each. Because Mom's basis is $3 million and her actuarial life expectancy is 12 years, $250,000 of each payment will be considered a return of capital and will be tax free. $166,667 of each payment will be considered capital gain and will be taxed at capital gains rates. The remaining $282,830 will be considered interest and will be taxed as ordinary income.

When Mom dies, she will have paid capital gains taxes on $333,334 ($166,667 x 2 payments), or $50,000. She will have paid ordinary income taxes on $565,660 ($282,830 x 2), or $198,000, assuming a 35% tax rate.

As a result, Mom will be left with a net amount of $1,150,992 in her estate [($699,496 x 2) – $50,000 – $198,000], assuming she had not spent any of the cash. This amount would generate $529,456 in estate taxes ($1,150,992 x 46%), assuming Mom had no estate tax exemption remaining at her death.

The trust will receive a basis in the assets equal to the two annuity payments actually made, or $1,398,992 ($699,496 x 2). If the trust subsequently sells the assets for $5 million, it will owe $540,151 in capital gains taxes [($5 million – $1,398,992) x 15%].

3. Consequences if the Annuity is Secured

If the annuity were secured, upon the initial sale, the seller would immediately recognize gain to the extent that the fair market value of the annuity exceeds the seller's basis in the asset. In our example, Mom would immediately recognize a gain of $2 million ($5 million fair market value – $3 million basis) and would owe $300,000 ($2 million x 15%) in capital gains tax.

As annuity payments are received by Mom, a portion will be considered a return of capital and thus tax-free, and a portion will be treated as interest and taxed as ordinary income. The tax-free portion would be equal to $416,667 and the ordinary income portion would be equal to $282,830. Thus, Mom would pay yearly income taxes of approximately $99,000, assuming a 35% tax rate.

4. Consequences if Mom Outlives Her Actuarial Life Expectancy

Note that, if Mom lives longer than her life expectancy of 12 years, any annuity payments she receives after the 12th year will be taxed wholly as ordinary income. If such a scenario were to occur, Mom would pay income taxes on $699,496, or $244,824, assuming a 35% tax rate.

5. Consequences under Example 2

In Example 2, Mom would transfer assets into the LP, and then the purchaser would buy a limited partnership interest from her. Therefore, the purchaser's partnership interest would have a basis equal to the annuity payments actually made, which could be as low as zero if Mom died before any annuity payments are made.

However, the LP's basis in the underlying assets would not be affected by the sale or by Mom's death (if there is no § 754 election made), and the LP could buy and sell assets without recognizing a large capital gain. If the LP sold the assets for $5 million, it would recognize a gain of $2 million ($5 million – $3 million), and would owe $300,000 in capital gains taxes ($2 million x 15%).

Essentially, this allows Mom's heirs to postpone paying the $450,000 balance of capital gains tax until the assets are distributed from the LP. At a minimum, any such distribution can be postponed until Mom's heirs need liquid funds from the LP.

6. Consequences under Example 4

In Example 4, for income tax purposes, the grantor trust will not be recognized as an entity separate from Mom. Therefore, the use of a grantor trust as the purchaser would result in no "sale" occurring upon the initial transfer of assets from an income tax standpoint. All of the payments received by Mom are tax free, and the basis of the purchased assets is not adjusted either upward or downward. In other words, Mom would pay no income or capital gains taxes during her life, and the trust would receive a basis of $3 million in the assets.

However, at Mom's death, she would have received two annuity payments of $699,496 each. Because the payments were not subject to income taxes, the total amount of the payments would be included in her estate to the extent that she had not spent them. Therefore, they would generate $643,536 in estate taxes [($699,496 x 2) x 46%], assuming Mom had no estate tax exemption remaining at her death.

7. Summary

Below is a chart summarizing the income and estate tax consequences of the examples discussed above:

	Income Tax Consequences to Seller		Income Tax Consequences to Purchaser		Estate Taxes	Total Income and Estate Taxes
	Ordinary Income Taxes (35% tax rate)	Capital Gains Taxes	Transferee's Basis in Assets/LP Interest	Capital Gains Tax on Later Sale of Assets	(46% tax rate)	
Example 1	$0	$0	$0	$750,000	$0	$750,000
Example 2	$0	$0	$0	$300,000	$0	$300,000
Example 3	$198,000	$50,000	$1,398,992	$540,151	$529,456	$1,317,607
Example 4	$0	$0	$3,000,000	$300,000	$643,536	$943,536
No Private Annuity	$0	$0	$5,000,000	$0	$2,300,000	$2,300,000

E. DETERMINING WHEN A PRIVATE ANNUITY IS ADVISABLE

The client should be advised of the possible consequences of each scenario discussed above. In order to evaluate the tax consequences of a private annuity transaction, the client needs to compare the estate tax and income tax consequences that would occur if the private annuity transaction were not entered into as opposed to those that would occur if the transaction were entered into.

If the private annuity transaction is not entered into, the assets would be included in Mom's estate, likely triggering estate taxes, but there would be no income tax consequences and Mom's heirs would receive a stepped-up basis in the assets after her death. If the private annuity transaction is successfully undertaken, Mom's estate avoids paying estate taxes, but she must pay income taxes on portions of the annuity payments. In addition, Mom's heirs risk having a very low basis in the property purchased, triggering higher capital gains taxes when the assets are eventually sold.

In addition to the various tax consequences possible under each scenario, the specific facts and circumstances of the client's situation should be considered, which may include the following:

- Whether the client has high-basis assets to sell. When the basis of the assets is relatively high, there is a risk that the client could pass away after only a few annuity payments are made. In such a case, the purchaser could have a "step-down" in basis. However, this consideration should be weighed against the fact that, as the seller receives annuity payments, a greater portion of the assets would be tax-free, resulting in lower capital gains and income taxes.

- Whether the client has low-basis assets to sell. If the client passes away shortly after the transaction, a step-down in the basis may not occur when the asset already had a low basis in the hands of the client. The basis may actually be higher in the hands of the purchaser after the annuity payments are made than it was in the hands of the seller. In addition, the client will recognize more income as the annuity payments are received because a larger portion of the payments will be attributed to capital gains and interest.

- Whether the purchaser is likely to sell the assets. If the asset is likely to be retained by the purchaser for many years, the income tax consequences that would occur upon the later sale of the asset become a less significant factor.

- The client's actuarial life expectancy versus the client's actual life expectancy. For example, a ninety-year old client may have an actuarial life expectancy of only four years. If she contracts an illness, shortening her actual life expectancy to only two or three years, a private annuity transaction will provide little benefit. In addition, if the client lives four or five years, her gross estate would actually increase as a result of the transaction.

  Essentially, the benefit of the private annuity transaction tends to decrease as a client ages because the difference between the client's actuarial life expectancy and actual life expectancy decreases.

F. STRUCTURING THE PRIVATE ANNUITY TRANSACTION

The theory behind the private annuity transaction is that the sale of assets for a private annuity will qualify as a valid sale for full and adequate consideration for tax purposes. However, special care should be taken to avoid structuring the transaction in a way that would cause the IRS to challenge it on the grounds that the sale was in substance a bargain sale (with a gift component) or a sale to a trust with a retained life estate.

For instance, the trust that purchases the assets should be adequately funded so that it is able to make the annuity payments. If a new trust (which could be structured as a grantor trust) is utilized, the client should consider making a gift of seed money to the trust prior to the sale. Most practitioners agree that a seed gift equal to 10% of the purchase price is the minimum amount needed to support a sale theory. In addition, the beneficiaries of the trust could personally guarantee the annuity payments, which would further bolster the sale theory.

The client could also decide to enter into the transaction with an existing trust if it has sufficient assets to obviate the need for a seed gift. However, it should be determined whether it would be more beneficial for the client to form a new grantor trust and make a seed gift if the existing trust is not a grantor trust.

II. SALE OF ASSETS IN EXCHANGE FOR A SELF-CANCELLING INSTALLMENT NOTE

A. DESCRIPTION

Similar to the sale of assets in exchange for a private annuity, a sale of assets in exchange for a self-cancelling installment note ("SCIN") involves the seller receiving a debt obligation which will terminate upon his or her death, with any remaining balance payable by the purchaser automatically cancelling. In order to compensate the seller for the risk of cancellation, the SCIN must have a risk premium which can be in the form of a higher interest rate or a higher sales price.

B. TRANSFER TAX CONSEQUENCES

There should be no gift upon the sale of the assets in exchange for the SCIN provided that the interest rate or principal is adjusted to compensate the seller for the self-cancelling feature. Since the note cancels upon the death of the seller, the note has no value for purposes of computing the seller's gross estate. The use of a SCIN was recognized as a bona fide sale by the Sixth Circuit in *Costanza v. Commissioner*, 320 F.3d 595 (CA-6, 2003), *rev'g* TCM 2001-128. The Sixth Circuit Court of Appeals held that a sale utilizing a SCIN was a bona fide sale of property; however, the Sixth Circuit remanded the case back to the Tax Court to determine if any portion of the SCIN was a "bargain sale" and therefore partially a taxable gift.

C. INCOME TAX CONSEQUENCES

The seller will recognize income each year depending upon how much of each payment is attributable to interest as well as the seller's income tax basis in the property sold. The buyer will take an income tax basis in the property equal to the sales price and will receive an income tax deduction equal to the interest paid year, which may or may not be deductible depending on whether or not the buyer has investment income.

D. PLANNING OPPORTUNITIES – SCINS AND PRIVATE ANNUITIES

Both SCINS and private annuities present excellent estate tax reduction strategies in this low interest rate environment.

From the perspective of the senior generation family member, a private annuity may be preferable if he or she needs the income stream from the sale to provide retirement income. The private annuity will continue for the life of the senior generation family member even though he or she outlives their actuarially determined life expectancy.

A SCIN may be more attractive to the junior family member if the junior family member has investment income which he or she can offset with the investment interest expense deduction generated by the SCIN payments, as opposed to the private annuity interest payments which must be capitalized. Also, the SCIN provides more flexibility in

structuring payment terms. A SCIN can be structured to provide for unequal payments which may be beneficial to the junior family member who is managing cash flow. Also, if the junior family member plans to use the asset acquired in a trade or business or dispose of the asset in a taxable transaction in the near future, the SCIN could be structured so that the risk premium to the senior generation family member is reflected in a purchase price above fair market value with a lower interest rate. By structuring the SCIN in this manner, the junior family member would receive a higher income tax basis for depreciation and sale purposes.

III. INCOME TAX BASIS PLANNING

A. GENERAL

One area that is often overlooked when dealing with a client for whom death is near is reviewing the separate versus community property nature of the client's property. The surviving spouse's income tax basis of all community property as well as the decedent spouse's separate property will be its value as of the date of death. The surviving spouse's income tax basis in his or her separate property will remain unchanged. These rules provide some planning opportunities. As the estate tax exemption amount increases over the next several years, the estate tax will not be a concern for as many people but income tax planning will still be important.

B. HEALTHY SPOUSE WITH BUILT-IN GAIN SEPARATE PROPERTY

If one spouse has separate property which has appreciated in value and the other spouse is in failing health, the healthy spouse can convert his or her separate property to community property. Upon the death of the ailing spouse, the income tax basis in the property will then receive a full step in basis to its fair market value as of the death of the first spouse. The surviving spouse can then dispose of the property without recognizing gain.

C. COMMUNITY PROPERTY WITH BUILT-IN LOSS

If a married couple owns community property which has declined in value so that their income tax basis exceeds its value, the property can be converted to the separate property of the healthier spouse to avoid a step down in basis to the fair market value of the property at the death of the first spouse if the property were to remain as community property.

IV. MARITAL PROPERTY PLANNING

If one spouse has significant wealth from separate property and the other spouse has low value separate property, it may be appropriate to do marital property planning when the poorer spouse is close to death in order to take full advantage of both spouses' estate tax exemptions. This is true particularly if the poorer spouse's assets are less than the estate tax

exemption amount.

For example, assume Husband owns $5 million as his separate property, Wife owns $250,000 as her separate property, and they own $500,000 together as community property. If Wife is dies, her estate will be worth only $500,000 (her separate property and ½ community property). As a result, her estate will be unable to fully fund the bypass trust, subjecting Husband and Wife's total estate to more estate taxes.

To remedy this problem, Husband could gift $1.5 million to Wife as her separate property, which would then be includable in her estate. Because she would then have a total of $2 million in assets ($1.75 million of separate property and $250,000 of her share of the community property), her estate could fully fund the bypass trust. Alternatively, Husband could create an inter vivos QTIP Trust benefitting Wife during her life and fund it with $1.5 million in assets. At Wife's death, the Trust would be included in her estate rather than in Husband's estate.

V. FLP PLANNING OPPORTUNITIES

A. FLP PACKING

For a client who has established an FLP that is "old and cold," the client could transfer additional assets into the FLP prior to death. The IRS does not like deathbed FLPs, but if the client had previously created an FLP which satisfies the *Kimbell* test of bona fide sale for full and adequate consideration, the IRS would have difficultly using § 2036 to bring all of the assets back into the client's taxable estate at their undiscounted value because the original transfer of assets to the FLP should be viewed as a separate and distinct transfer for § 2036 purposes. Another point to bear in mind is that if a client has a shorter life expectancy, he or she will not need to retain as many assets outside of the FLP in order to meet living expenses.

B. FLP INCOME TAX BASIS PLANNING

If the client owns an interest in an FLP and the FLP has appreciated assets (assets with a value greater than basis) and depreciated assets (assets with a basis greater than value), the FLP has the option to make a § 754 election upon the client's death, in which case all of the assets' bases would be increased or decreased to each asset's fair market value on the date of the client's death. The opportunity to preserve capital losses on the depreciated assets would then be lost.

Alternatively, the FLP could be divided into two separate partnerships, one owning the appreciated assets and one owning the depreciated assets. Upon the client's death, only the FLP owning the appreciated assets would make the § 754 election. The FLP owning the depreciated assets would forego making the election, thereby preserving the capital loss inherent in its assets.

VI. IRA ACCELERATION

For certain clients who have IRAs and are near death, it may be advisable for the client to withdraw all of the assets in the IRA prior to death in certain circumstances. The withdrawal will trigger income tax, but if the income tax is payable in the year of the client's death, then the income tax liability becomes an estate administration expense deductible under § 2053. Since the maximum estate tax rate is 48% and the maximum income tax rate is 35%, the withdrawal may produce an overall tax savings. One other factor to consider is whether or not the client's designated beneficiaries are likely to withdraw most or all of the IRA balance soon after the death of the client. If this is the case, the value of the ability of the beneficiaries to prolong the income tax deferral on the growth of the assets will be lost.

For example, assume an unmarried client has a $5 million taxable estate, with a $1 million IRA balance. Upon the client's death, the IRA will generate $460,000 of estate tax. If the IRA beneficiary then decides to withdraw all of the funds in the IRA, then $350,000 of income tax will be due as well (ignoring the effect of the IRD income tax deduction), making the total tax liability $810,000. In contrast, if the client withdrew the funds from the IRA prior to death, the same $350,000 income tax liability would be due. However, only the net IRA proceeds of $650,000 would be includable in the taxable estate, which would generate an estate tax liability of $299,000. As a result the total tax liability would be $649,000 as opposed to $810,000, for a savings of $161,000.

VII. CHARITABLE PLANNING WITH IRAS AND RETIREMENT PLANS

A. AT DEATH

If an individual plans to make a charitable gift at his or her death, naming a charity as the beneficiary of an IRA or other retirement plan can maximize the amount of money the charity receives, as well as the amount of money that the individual's family receives.

In addition, naming one's spouse as the primary beneficiary and a qualified charity as the secondary beneficiary of a retirement plan (or, in the alternative, the charity as the primary beneficiary) provides an individual with an opportunity to benefit their charity of choice with a minimal impact on their heirs.

IRAs and retirement plans are attractive vehicles for leaving assets to a charity because of the double taxation imposed on IRAs at death. Estate taxes are paid by the participant's estate on death, and income taxes are paid by heirs as withdrawals are made. This double taxation makes retirement plans extremely poor vehicles for passing wealth to one's descendants.

When an individual names a charity as the beneficiary of an IRA, the IRA is still fully includable in his or her taxable estate, but the estate receives a charitable deduction equal to the amount passing to the charity. Because the charity will not be required to pay income taxes on IRA withdrawals, the charity ultimately pockets the entire IRA. The impact on the

individual's heirs is minimized by the fact that had they been named beneficiaries of the IRA, estate taxes and income taxes could have left them with as little as 19¢ on the dollar.

Example: Donor owns a $100,000 IRA. His wife predeceased him, and he has two children whom he names as beneficiaries of the IRA. If Donor dies with a taxable estate, his $100,000 IRA could be subject to estate taxes as high as $46,000 ($100,000 x 46% estate tax rate). Therefore, only a net amount of $54,000 from the IRA would pass to his children. Distributions that they take from the IRA to pay the estate taxes will be subject to income taxes, as will distributions they take for their benefit during their lives. The income taxes generated by these distributions could be as high as $35,000 ($100,000 x 35% income tax rate). As a result, Donor's children could receive as little as $19,000 net of taxes from the $100,000 IRA ($100,000, less $46,000 in estate taxes, less $35,000 in income taxes). (Note: This example ignores the "income in respect of a decedent deduction" due to its limited benefit as an itemized deduction.)

Instead, Donor could name his favorite charity as the beneficiary of the IRA. His estate would receive a charitable contribution deduction in amount equal to the IRA, and the charity would receive the full $100,000. As the charity takes distributions from the IRA, it will not pay income taxes and will ultimately receive the full amount of the IRA.

Note: Because of the uncertainty of how much will actually remain in an individual's IRA at the time of death, if a specified amount is desired to pass to charity, the individual should include a provision in his Will leaving the charity of choice the desired amount, reduced by any amount passing to the charity by beneficiary designation on the individual's death.

B. DURING LIFE

Alternatively, the individual could withdraw assets from the IRA and contribute those assets to charity. The assets would not be included in the individual's estate, and the estate would receive a deduction for the income taxes paid on the withdrawal, so long as the individual dies in the year of withdrawal.

VIII. PREVIOUSLY TAXED PROPERTY CREDIT

If a partial (or no) QTIP election causes a taxable estate at the first death, and if those assets pass to a bypass trust with mandatory income to the survivor, or stays in the presumptive QTIP Trust which still requires mandatory income to the survivor, the survivor's estate will qualify for a § 2013 PTP credit, if the survivor dies within ten years of the first death. The credit is based on the estate tax paid on those assets in the estate of the first spouse to die which were left to the surviving spouse. In this case, the asset is the present value of the stream of mandatory income payments, calculated using the life expectancy of the surviving spouse. As long as the survivor has more than a 50% chance of living more than one year (determined on the date of the first spouse's death), then the IRS mortality tables can be used. See TAM 8512004 (residuary estate passed to bypass trust providing income to spouse for life; QTIP election was not made, generating estate tax at first death).

The PTP credit applies if the survivor dies within ten years of the first spouse. The theory behind the credit is that it would be a harsh result to subject the same property to estate taxation more than once in a short time period. The following table illustrates the credit's sliding scale.

Number of Years Between Death of First and Second Spouse	PTP Credit
1	100%
2	100%
3	80%
4	80%
5	60%
6	60%
7	40%
8	40%
9	20%
10	20%

The PTP credit is calculated by multiplying the Federal Estate Tax of the first spouse to die by a fraction designed to allocate to the credit the portion of that tax attributable to the property received by the surviving spouse. The numerator of the fraction is the Net Property Transferred to the Survivor and the denominator is the Adjusted Taxable Estate of the first spouse. The following definitions apply:

Federal Estate Tax - the federal estate tax paid by the estate of the first spouse to die (excluding inheritance taxes paid to a state), plus any PTP credit allowed the estate or any credit allowed for gift taxes paid on prior transfers.

Net Property Transferred to the Survivor - the value of the property transferred to the surviving spouse (as such property is valued in determining the federal estate liability of the first spouse), less any debts, expenses and taxes chargeable to such property.

Section 2013(c) imposes a limitation on the amount of the PTP credit. The credit is limited to the amount by which the estate tax imposed on the survivor's estate (computed without considering any PTP credit to which the estate is entitled), exceeds the amount that estate tax would be if it was determined by excluding from the gross estate the Net Property Transferred to the Survivor.

Note that the PTP credit applies as long as assets which were taxed in the first estate pass to the survivor. There is no requirement that the transferred assets be included in the survivor's estate. In this case, although the stream of mandatory income payments vanishes at the survivor's death, the credit is still based on their value as of the date of the first spouse's death.

IX. PLANNING FOR INCAPACITY

It is important to be sure the client has the appropriate documents in place before disability occurs. This includes having the following documents executed and on file:

1. Power of Attorney, naming someone who can handle financial matters on behalf of the client.

2. Medical Power of Attorney, appointing the person that can make medical decisions on behalf of the client in the event of his or her incapacity.

3. Directive to Physicians, which allows the client to direct whether life support should be continued in the event that the client is diagnosed with a terminal or irreversible condition.

4. Declaration of Guardian, where the client designates whom he or she would like to serve as guardian of her person and estate, should one need to be appointed.

5. HIPAA Waiver, in which the client authorizes medical professionals to release his or her medical information to certain named individuals.

To assist in management of the client's assets after his or her disability, the client should also have a revocable living trust in place, with a back-up trustee named to serve as trustee after the client is no longer able. The back-up trustee can fund the client's assets into the living trust, providing for streamlined and more centralized management.

X. PSYCHOLOGICAL ISSUES IN DEALING WITH CLIENTS WHO ARE NEAR DEATH

Discussing these types of planning techniques with clients can be difficult because the utilization of the techniques runs counter to the hope that most clients have of successful recovery from their illness.

We suggest informing the client of these techniques during routine estate planning discussions, well in advance of the client being diagnosed with such an illness. In addition, if practitioners have a relationship with the client's children, the children can be on the alert when a parent's health begins to fail.

It is also important to note that, due to a recent Texas Supreme Court case, scrutiny of practitioners in the tax and estate planning arena has increased. In *Estate of Terk v. Oppenheimer, Blend, Harrison & Tate, Inc.*, No. 04-0681 (Tex. May 5, 2006), the Texas Supreme Court held that the executor of a decedent's estate had standing to sue the decedent's estate planning counsel for failure to advise the decedent of estate-tax saving techniques.

While it remains to be seen whether the executor will succeed in proving that the decedent's counsel actually failed to advise the decedent of such techniques, this case highlights the liability exposure to practitioners who hold themselves out as estate planning professionals. Therefore, you should be sure your clients are aware of the estate planning techniques available to them, or you should refer them to another expert who can handle their estate planning needs.

APPENDIX

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DEATHBED CHECKLIST

prepared by Marvin E. Blum

EXAMINE ESTATE PLANNING DOCUMENTS

☐ 1. Examine Will. Check signatures (testator and witnesses), notary, etc.

☐ 2. Verify that the client has executed the following documents:

- ☐ A. Power of Attorney (with power to make gifts, etc.). (Note: Texas statutory power of attorney became effective September 1, 1997.)
- ☐ B. Medical Power of Attorney. (Note: Texas statutory medical power of attorney became effective September 1, 1999.)
- ☐ C. Directive to Physicians. (Note: Texas statutory directive to physicians became effective September 1, 1999.)
- ☐ D. HIPAA Waiver.

☐ 3. Consider creating a revocable trust (living trust) [or fund an existing revocable trust] to manage financial assets in the event of disability.

☐ 4. Examine how all accounts are titled – avoid survivorship (JTWROS) or "pay on death" designations.

☐ 5. Review all fiduciary appointments – executor, trustee, other agents.

☐ 6. Examine life insurance (beneficiary designations; increase coverage if there are guaranteed insurability options; convert to permanent insurance if convertible term will soon lapse).

☐ 7. Ensure access to bank accounts and safe deposit box by naming someone in addition to the client on the signature card. (But avoid titling JTWROS.)

SIMPLER TECHNIQUES

☐ 1. Real Estate – avoid probate by deeding to a Living Trust, or by making a gift and deeding during lifetime (retain a life estate in order to get a stepped-up basis). This is especially important for out-of-state real property (including mineral interests) in order to avoid ancillary probate.

☐ 2. Make $12,000 annual exclusion gifts to as many beneficiaries as possible (if estate is over the exemption level). To be recognized by the IRS as completed gifts, checks must clear the bank before death occurs.

☐ 3. Consider converting charitable bequests in the Will into lifetime transfers to take advantage of the income tax deduction for charitable gifts made during life.

☐ 4. Consider naming a charity as the beneficiary of IRAs and retirement plans.

☐ 5. Clarify domicile questions, and if uncertain, take steps to bolster claim for Texas domicile.

☐ 6. Review limited partnership/limited liability company documents, if any, and consider funding additional assets into the partnership/LLC.

☐ 7. Consider accelerating income taxes by withdrawing the client's entire IRA, thereby permitting an income tax deduction on the estate tax return.

MORE COMPLEX TECHNIQUES

☐ 1. Utilize losses and avoid basis "step-down" on assets which have declined in value. Either sell the asset before death, or make the asset the healthier spouse's separate property so it will not receive a step-down in basis when the ailing spouse dies.

☐ 2. Make gifts of appreciated assets to the dying person to get a stepped-up basis at death.

CAVEAT: Section 1014(e) disallows a step-up in basis if property is transferred within one year of death and if such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor). See TAM 9308002.

☐ 3. If one spouse has substantial separate property, and it appears that the non-propertied spouse could die first, make a gift to the non-propertied spouse to equalize estates (or at least give the non-propertied spouse enough assets to use the full unified credit exemption if the non-propertied spouse dies first). To save taxes, the Will of the first to die must contain a Bypass Trust.

☐ 4. Consider a sale of assets in exchange for a private annuity or a self-cancelling installment note.

☐ 5. Consider creating a charitable lead trust or charitable remainder trust.

☐ 6. Prepare to obtain the closely-held business estate tax deferral. In order to qualify for an estate tax deferral under Section 6166, the decedent must own at least 20% of the closely-held business (either a partnership having 45 or fewer partners or a corporation having 45 or fewer shareholders or a trade or business carried on as a sole proprietorship). In addition, the value of the decedent's interest in a closely-held business must exceed 35% of the adjusted gross estate.

☐ 7. For a married couple, consider paying some estate tax when the first spouse dies if the second spouse is in ailing health in order to take advantage of the PTP credit.

MISCELLANEOUS

☐ 1. Take steps to avoid acceleration of income in respect of a decedent ("IRD") by using IRD assets to fund pecuniary bequests as a last resort. Acceleration of IRD can be avoided by making specific bequests of IRD items or by funding IRD items as part of the residuary estate.

☐ 2. Be sure that the dying spouse has provided for his or her community property interest in nonqualified retirement plans and IRAs belonging to the surviving spouse to pass outright to the surviving spouse.

☐ 3. Consider the need to prepare a business succession plan.