Overview of Wealth Transfer Taxes

By,

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For most of the 20th century and at key points throughout American history, the federal government has relied on estate and inheritance taxes as sources of funding. The modern transfer tax system, introduced in 1916 provides revenue to the federal government through taxes on transfers of property between living individuals as well as through a tax on transfers of property at death.

Taxation of property transfers at death can be traced back to ancient Egypt as early as 700 BC. Nearly 2000 years ago, Roman Emperor Caesar Augustus imposed the Vicesina Hereditatium, a tax on successions and legacies to all but close relatives.

In the United States, the Revenue Act of 1916 was passed that provided that the federal estate tax was applied to net estates (gross estates less deductions). The exemption amount was initially $50,000. The estate taxes were graduated from one percent on the first $50,000 to ten percent on amounts over $5,000,000. Taxes were due one year after the decedent's death, and a discount of 5% was allowed for payments made within one year of death.

Then, in 1976, the estate tax system and the gift tax system were combined to provide a single graduated rate of tax imposed by both lifetime gift and testamentary dispositions. The 1976 tax reform package also introduced a tax on generation skipping transfers. There have been other changes to the estate tax law to get us to where we are today. Today, the Federal Estate Tax is set forth beginning in § 2001 of the Internal Revenue Code. (26 U.S.C. 2001). This section provides that upon death, the decedent's gross estate includes the then current fair market value of all property interests held by the decedent at the time of his or her death, whether passing by operation of law (such as joint tenancy assets), by operation of contract (such as insurance proceeds), or by operation of probate laws. There are deductions for debts, administrative expenses, qualified transfers to spouses, and transfers to qualified charities. The net amount is the taxable estate. To the extent the applicable exclusion has not been utilized for lifetime gifts, it will be applied to the taxable estate. The estate tax is paid out of the taxable assets, so the amount of the estate tax itself is actually included in the computation of the tax.

Prior to the tax law changes taking effect in 2002, all transfers of money or property (outright, or by Will or Trust) - during life or at death - were subject to a single, Federal Unified Gift and Estate Tax system. Since the estate tax - but not the gift tax - is set for repeal after 2009, however, it may no longer make sense to talk about a "unified" system. Fortunately, the new law still allows some significant transfers to be excluded from the estate tax, while it lasts, and the gift tax, which we are stuck with. In addition to

those exclusions, presented later, each person has a general exemption, or shelter against the federal gift and estate tax.

For many years, that sheltered amount had been $600,000. For persons who died in 1998, however, the sheltered amount was $625,000. For persons dying in 2000 and 2001, everyone's "standard" sheltered amount was $675,000. Pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001, the "exemption amount" - the amount sheltered from estate tax, but not from gift tax is scheduled to continue to increase through 2009, after which the estate tax itself is scheduled for elimination. These changes are set forth in the table below:

Calendar year	Estate Tax Exemption (per person)	Highest estate and gift tax rates
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	N/A - Estate tax repealed (but gift tax NOT repealed)	Gift tax rate = top individual income tax rate

There is a self-repeal feature in the 2001 tax law. The new rates and exemption amounts end automatically after 2010. Unless further legislation in passed, we will return to the pre-2001 estate tax structure.

Prior to the 2001 law, estates containing small family owned businesses received additional tax benefits. These tax benefits are phased out in the new estate tax structure, primarily because the unified credit amount increases to an amount greater than that provided for these business interests under the prior plan.

Lifetime gifts, if they do not qualify as one of the tax exclusions below, begin to "use up" the above-listed exemption (the tax shelter). Whatever portion of the $1 million (for 2002) that is not used for lifetime gifts is available to reduce or eliminate estate taxes at death. So, assuming a decedent has not used any of the shelter by making non-excludable lifetime gifts, no federal tax is due on the first $1 million of his estate. But then, the rates begin at 37%, and go to 50% (to be reduced to 45%, in steps, until elimination of the estate tax after 2009).

Effective January 1, 2004, the family owned business deduction was repealed.

The federal estate tax credit for estate taxes paid to state(s) is reduced as follows:

Year	Percentage of State Death Tax Credit Allowed Shown as a Percentage of 2001 Amount
2002	75%
2003	50%
2004	25%
2005 and thereafter	none B however, deduction for state taxes actually paid

When one spouse dies, community property assets receive a full step-up in basis. This reduces the capital gains tax that would be due when the assets are eventually sold. With joint ownership, only the deceased's share would receive a step-up in basis - so the owner would have a bigger gain (profit) when the assets are sold, and would pay more in capital gains tax.

If the client lives in a non-community property state (such as Utah) and has owned an asset jointly with a spouse since before 1976, the asset may be entitled to a full step-up in basis when one spouse dies. If the title is thereafter changed, the full step-up is lost - the deceased spouse's share would still get a step-up, but the surviving spouse's share would not. If the asset is a personal residence, losing the full step-up will not be a problem unless the gain is more than $500,000. (If the client is married, up to $500,000 of the gain on the sale of his personal residence is now exempt from capital gains tax.) But the lack of full step up could be a problem for other assets like farmland, commercial real estate or stocks.

B. Gift Tax

The Federal Gift Tax is set forth beginning in 26 U.S.C. 2501. Generally, the Gift Tax applies to any transfer made without receiving value in return and without regard to intent. There are however, exclusions from gift tax. Gifts between spouses and gifts to qualified charities are not subject to gift tax.

In addition, there is an annual exclusion from gift tax for gifts of present interests. The amount of these gifts is $11,000 per donee per year. This means that cash and/or property worth up to $11,000 can be given without tax consequences to each of an unlimited number of recipients. ($22,000 per year, per recipient, if both spouses give or if one spouse elects to split the gift of the other spouse.) These gifts do not count against the $1 million shelter. They require no paperwork, and are income tax-free (as are all gifts) to the recipient.

To qualify, the gift to each donee must be outright - a present right to spend or use the property with no strings attached - not a promise of a future benefit. This requirement means that most gifts in trust do not qualify unless certain procedures are followed.

Illustration: A husband and wife sell a house to their son for $50,000, when it is worth $120,000. A $70,000 gift has been made ($120,000 - $50,000). The parents elect to split it, so that both of their $11,000 annual gift tax exclusions can be used. This $22,000 combined exclusion results in a taxable gift of $48,000 to the son ($70,000 - $22,000). A federal gift tax return should be filed, but no tax is now due. Instead, because the gift has been split, each parent uses $24,000 of his/her $1 million (for 2002) lifetime shelter to "protect" the gift from all tax. The son pays no tax on the gift. (True gifts of any size are always free from federal income tax.) Assuming this has been their only taxable gift to anyone, each of the parents will then have a shelter of $976,000 remaining to shield future transfers - lifetime gifts or at death - from federal estate tax. The gift tax return that is filed with no payment allows the IRS (and the family) to keep track of how much of the unified credit has been used.

The above situation - where parents want to help their children buy a house – is a common manner of gifting. A better way to handle this transfer might be to sell the house to the child at full price. Then, each year the parents can make a $22,000 gift, in the form of debt forgiveness. By forgiving the debt gradually, the parents can take advantage of each of their annual $11,000 exclusions, and not use any of their two $1 million shelters. While we will discuss debt forgiveness in more detail later, it is important to note that we assume in this example that the child is paying interest on the loan to the parents.

Gifts of any size to a spouse or to a qualified charity -lifetime or at death - do not "use up" any of the $1 million gift tax shelter, and are not included in the tax calculation.

In addition, payments made directly to a college or university for the education of a beneficiary are free of gift tax. Payments must be made *directly* to the institution, not just earmarked for this use and given to the beneficiary.

The amount sheltered from gift tax is $1 million per person in 2002, but does not rise further. Remember, the tax on lifetime gifts is not set for repeal, and the increase in the sheltered amount is much less than what is now scheduled for transfers of property occurring after death. The exemption for lifetime gifts - each person's sheltered amount - previously has been equal to whatever the shelter was that year for the estate tax. But now, the shelter for lifetime gifts has increased to $1 million in 2002 but will remain at that rate.

Calendar year	Gift Tax Exemption (per person)	Highest gift tax rates
2002	$1 million	50%
2003	$1 million	49%
2004	$1 million	48%
2005	$1 million	47%
2006	$1 million	46%
2007	$1 million	45%
2008	$1 million	45%

2009	$1 million	45%
2010	$1 million	top individual income tax rate

Another rule to be wary of in the gift tax structure is that gifts made within three years before a decedent's death may be included in the decedent's estate for estate tax purposes. The types of gifts which invoke this rule are gifts with a retained life estate, transfers taking place at the decedent's death, revocable transfers and life insurance policy transfers. In addition, gift taxes paid on transfers made within three years of the decedent's death are includible in the decedent's gross estate for estate tax purposes pursuant to Section 2035 of the Internal Revenue Code. Accordingly, gifts made within three years of death need to be closely scrutinized.

C. Generation Skipping Transfer Tax

Congress enacted the generation-skipping transfer tax (GSTT) which applies to transfers to "skip persons", whether made during life or at death. "Skip persons" are basically grandchildren and lower generations. The GSTT is a one-rate tax equal to the highest applicable estate tax rate, and it applies in addition to any applicable gift or estate tax. Estate taxes paid are deducted before computing the GSTT, but combination of the estate tax and the GSTT can result in a combined rate of over 70%.

Each donor or decedent has a $1,060,000 GST exemption (for 2001), which can be used for transfers either during life or at death. The GST exemption applies to the transferor (donor or decedent) regardless of the number of skip persons to whom the transfers are made. In 2004 and later, the GST exemption will be the same as the "applicable exclusion" for estate tax purposes.

This tax is somewhat confusing and often misunderstood. The basic premise behind the generation skipping transfer tax - which is a tax that is separate and apart from income, estate and gift taxes - is to trap transfers of property within each successive generation. In other words, it is designed to allow transfers to spouses and children but to tax transfers going to grandchildren and those deemed to be two or more generations below that of the person making the transfer. This tax is very steep - it is a flat 55% of the value of the property transferred (the rate drops from 55% to 45% in steps through 2007 where it will remain until 2010).

Those who transfer all of their property to someone who is deemed to be in the same or one generation below do not have to worry about this tax.

Many people escape imposition of the generation skipping transfer tax by transferring property only to those at his/her same generation or no more than one generation below - along with the allocation of the $1,060,000 (in 2002) exemption.

While almost everyone is aware that there has been a purported "repeal" of the Federal Estate Tax effective in 2010 (but *only* for 2010 absent Congressional action), the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA" or the "2001 Act") also made several significant changes to the generation-skipping transfer tax provisions. Like the Federal Estate Tax, the GST is also scheduled to be repealed for transfers to "skip persons" in the year 2010. Until that time, the GST rate will decline in tandem with the decline in the highest estate tax rate.

The exemption amount will also increase in tandem with the increase in the exemption for estate tax purposes, except that in 2002 and 2003, the GST exemption will be a $1 million exemption as adjusted for inflation, which for 2002 will be $1,100,000. (But note that the 2001 Act only expanded the gift tax exemption to $1,000,000 and the gift tax is not repealed in 2010).

Under pre-EGTRRA, GST exemption was automatically allocated to direct skips to the extent necessary to make the "inclusion ratio" zero. If the transfer exceeded the amount of the taxpayer's remaining GST exemption, the entire remaining exemption amount would be allocated to that transfer. The taxpayer could elect not to have the GST exemption allocated to the transfer. There was, however, no similar provision for a transfer for anything other than a direct skip. EGTRRA attempts to remedy this problem by providing for a similar automatic allocation of GST exemption for "indirect skips" from a "GST Trust." As always, it is critical to understand the statutory definition of the terms provided in the Internal Revenue Code. "Indirect skip" means any transfer of property that is Not a direct skip; Subject to gift tax; and Made to a "GST Trust." IRC §2632(c)(3)(A).

A "GST Trust" is defined, in turn in IRC §2632(c)(3)(B) as any trust for which a taxable termination or taxable distribution can take place, except for the following exceptions:

1. The trust provides that more than 25% of principal must be distributed to or may be withdrawn by one or more non-skip persons
    a. On or before the individual's 46th birthday;
    b. On or before one or more dates specified by the trust instrument that will occur before the individual's 46th birthday; or
    c. Upon the occurrence of an event that may be reasonably be expected to occur before the individual's 46th birthday (in accordance with regulations to be promulgated)
2. The trust provides that more than 25% of the trust principal must be distributed to, or may be withdrawn by, one or more non-skip persons and who are living on the date of death of another person who is more than 10 years older than such individuals;
3. The trust provides that if one or more individuals who are non-skip persons die before the dates described in 1., above, or 2., above, then more than 25% of the trust principal will be distributed to such individual's estate or be subject to a general power of appointment exercisable by such person.

4. Any portion of the trust that would be includible in the estate of a non-skip person (other than the transferor) if the non-skip person died immediately after the transfer.
5. A charitable lead annuity trust ("CLAT"), a charitable lead unitrust ("CLUT"), a charitable remainder annuity trust ("CRAT") or a charitable remainder unitrust ("CRUT").

Note that a Crummey power does *not* qualify to take a trust out of the "GST trust" definition. IRC §2632(c)(3)(B). Also, it is assumed that any powers of appointment exercisable by a non-skip person will not be exercised. In the event that a deemed allocation of GST exemption for an indirect skip is for property that would be includible in the person's gross estate for Federal estate tax purposes (the so-called "estate tax inclusion period" or "ETIP"), the deemed allocation is treated as having occurred at the end of the ETIP rather than when the property is actually transferred to the trust. IRC §2632(c)(4). The value of property for determining the inclusion ratio is the value at the close of the ETIP. IRC §2642(b)(1)(B).

The automatic allocation of GST exemption for indirect skips applies to transfers subject to estate or gift tax that are made after December 31, 2000 and to ETIPs ending after December 31, 2000. Section 561(c)(1) of the 2001 Act.

In other words, transfers made in calendar year 2001 are subject to this automatic deemed election.

The allocation is automatic unless a timely filed election *out* of the deemed allocation is filed. IRC §2632(c)(5)(B)(i)(I) provides that election out is deemed timely if it is made

1. On a timely filed gift tax return for the calendar year in which the transfer was made;
2. On a timely filed gift tax return for calendar year in which there would be an automatic allocation for the close of an ETIP; or
3. On any other dates prescribed by the IRS.

An election out of the deemed election can also be made to *any or all* transfers made by a particular individual to a particular trust. IRC §2632(c)(5)(A)(i)(II). The election is made on a timely filed gift tax return for the calendar year in which the election is to become effective. IRC §2632(c)(5)(B)(ii). Similarly, an individual can also elect, on a timely filed gift tax return, to have a deemed allocation to any or all transfers made by an individual to a trust that is *not* a GST Trust by having such trust be deemed as a GST Trust. IRC §2632(c)(5)(A)(ii).

The 2001 Act gives the IRS power to extend the time to allocate GST exemption, elect out of automatic allocations, and to grant exceptions to time requirements. IRC §2642(g)(1). If the relief is granted, then the value of the transfer for purposes of GST exemption allocation and computing the inclusion ratio is determined on the date of the transfer to the trust.

In the absence of such relief being granted by the IRS, IRC §2642(b)(3) permits late allocations of inter vivos transfers based on valuation at the time the allocation is made with IRS. This is sometimes useful from a planning standpoint (such as for contributions to a trust holding only term insurance), but is generally not the preferred course of action for property that, the donor would hope, will rise in value.

The standard that the IRS must use in order to determine whether to grant an extension and or to make an exception to the deadlines is the same as for a "regulatory election" for purposes of IRC §9100 and the underlying regulations. IRC §2642(g)(1)(B). The IRS is required to promulgate regulations detailing circumstances and procedures, including procedures for requesting comparable relief for transfers made before the enactment of the 2001 Act.

Aside from relief for failure to make allocations and elections, the 2001 Act also requires the IRS to overlook mistakes made in the mechanics of allocating GST exemption. A GST exemption allocation that demonstrates an intention to have lowest proper inclusion ratio is deemed to be, under the new substantial compliance rules, an allocation of so much of unused GST exemption as to produce lowest possible inclusion ratio. IRC §2642(g)(2). The IRS is required to take into account all relevant circumstances, including evidence of intention contained in trust instrument or transfer document. Thus, an un-artfully drafted allocation cannot be used against the transferor if the evidence suggests that he or she intended to create the lowest possible inclusion ratio (and therefore the lowest ultimate tax) – the IRS must, by statute, read the allocation and the surrounding facts in the manner that would produce the lowest inclusion ratio.

The 2001 Act provides that a trust can be severed at any time to permit split-up into two trusts – one with a zero inclusion ratio and one with an inclusion ratio of one. In order to do this, the split-up must be a "qualified severance" under IRC §2642(a)(3).

A split-up is a "qualified severance" if

1. A single trust is divided, under provisions of the governing instrument or under state law) on a fractional basis; and
2. The terms in both new trusts provide for same succession of interests of beneficiaries that were provided in original trust.

IRC §2642(a)(3)(B)(i).

If the trust's inclusion ratio is greater than zero and less than one (i.e., the trust has been funded and the property transferred exceeds GST exemption), the trust must be divided into two trusts in the following manner:

1. One trust must receive a fractional share of trust assets that equals the applicable fraction immediately before the severance (i.e., trust property to which exemption allocated over total property transferred to trust); and

2. The trust receiving the fractional share based on the applicable fraction is assigned an inclusion ratio of zero (i.e., no GST paid from the trust) and the other has an inclusion ratio of one.

The Code was also amended to give a taxpayer the opportunity to rectify the lack of GST exemption allocation where an unexpected death of a non-skip person (i.e., the death of a child) occurred. This opportunity to make retroactive GST exemption allocations should not be confused with a so-called “generational step-up” that had previously existed (and still exists) where the non-skip person had died *before* the transfer was made (IRC §2651(e)(1)) – in such a case, there is no need to allocate GST exemption because the grandchild, for example, would not be a skip person. This new provision (IRC §2632(d)(1)) allows a transferor to allocate GST exemption to one or more transfers to which no allocation was made previously – ostensibly because the transferor thought that the other person would receive the property and thus no GST would be incurred.

In order to take advantage of a retroactive allocation, the person who died who had an interest or future interest in trust must have been a lineal descendant of the grandparent of the transferor, transferor’s spouse or the transferor’s former spouse, and must be assigned to a generation below the transferor’s assigned generation. If a retroactive allocation is made, exemption is deemed allocated to previous transfers to the trust on chronological basis.

If the retroactive allocation is made by a gift tax return filed on or before the date for filing a gift tax return for the calendar year in which the non-skip person died, the value of the transfer for the purpose of the GST exemption allocation is as of the date of the original transfer. IRC §2632(d)(2).

D. Taxes on the Horizon: Loss of the Basis Step Up at Death

Under present law, if the recipient of a gift later sells the gift property, he or she generally uses the donor’s tax basis in determining gain or loss. (Basis typically represents the property’s original cost plus or minus various adjustments required after acquisition.) Thus, essentially, the donor’s basis is “carried over” to the recipient. This carryover basis, however, generally cannot exceed the asset’s fair market value on the date of the gift.

On the other hand, property passing from a decedent’s estate generally receives a “stepped-up” basis. The basis of the asset becomes the fair market value of the asset as of the date of death or the alternate valuation date up to six months after death. This stepped-up basis allows a beneficiary of an estate who sells the property to avoid tax on any appreciation in the value of the property that occurred before the decedent’s death. Section 1014 of the Internal Revenue Code (IRC) provides for a step-up in basis in property received from a decedent to the property's Fair Market Value (FMV) as of the date of death. For example, if the decedent purchased a painting for $50,000, and he owns it at the time of his death when it has a FMV of $1,000,000, the painting will be included in the taxable estate of the decedent and be subject to estate tax at the painting’s

FMV. When the heirs of the decedent sell the painting, their basis for income tax purposes will be the FMV as of the date of death. This means if the picture is sold for $1,000,000, theirs income tax basis will be the same as the sale amount; hence, no income tax will be due on the sale.

The new law overhauls the transfer tax system. Among the changes is a change in the way the tax basis of inherited assets is figured.

Starting in 2010, the new law repeals the old stepped-up basis rule for death-time transfers and replaces it with a modified carryover basis rule. In general, the basis of property received from a decedent will be the *lesser* of (1) the decedent's adjusted basis in the property or (2) the property's fair market value on the date of death.

Starting in 2010, the new law allows an executor or personal representative of an estate to increase (step up) the basis of assets acquired by the beneficiaries at the decedent's death, within certain limits. Each estate will generally be permitted to increase the basis of assets transferred up to a total of $1.3 million. Plus, the basis of property transferred to a surviving spouse may be increased by an *additional* $3 million, so the total step up for assets transferred to a surviving spouse will be as much as $4.3 million. Both the $1.3 million and $3 million figures will be adjusted for inflation occurring after 2010.