

# Chapter 26

## The Federal Gift and Estate Taxes

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# Transfer Taxes (slide 1 of 2)

- All gratuitous transfers are subject to a unified transfer tax including:
  - Estate tax
  - Gift tax

# Transfer Taxes (slide 2 of 2)

- Estate tax
  - Imposed on decedent's entire estate
  - Tax on the right to pass property at death
- Gift tax
  - Tax on inter vivos (lifetime) transfers for less than full and adequate consideration
  - Payable by the donor

# Tax Relief Reconciliation Act of 2001

- Made substantial changes to the unified transfer tax
  - Lowered top tax rates applicable to estates and gifts
  - Effectively eliminates the estate tax by 2010 but retains the gift tax
  - For budget reasons, eliminates all changes made by the Act after 12/31/2010
    - Referred to as a “sunset” provision

# Formula for the Federal Gift Tax

TOTAL GIFTS to which the gift tax might apply

- Gift tax deductions (charitable and marital deductions)

- Annual exclusions

= Taxable gifts made this year

+ Taxable gifts made in all prior years

= Total taxable gifts

Tax on total taxable gifts

- Tax paid or deemed paid on past taxable gifts

- Unified transfer tax credit

= Gift tax payable this year

# Formula for the Federal Estate Tax

Gross Estate

- Deductions

(expenses, indebtedness, taxes, losses, charitable bequests, and marital deduction, family business)

Taxable Estate

+ Taxable Gifts

Made after 1976

= Taxable Transfers

Tentative Transfer Tax

Consult Rate Schedule

- Gift Taxes

On post - 1976 gifts

- Tax Credits

Including the unified tax credit

= Estate Tax Due

On Taxable Estate

# Unified Tax Credit (slide 1 of 2)

- Allows donors and decedents to transfer modest amounts of wealth without being subject to gift and estate taxes
  - Exemption equivalent is amount that can be transferred tax-free through the unified tax credit

# Unified Tax Credit (slide 2 of 2)

<u>Year</u>	<u>Credit</u>	<u>Exempt. Equiv</u>
2001	\$220,550	\$ 675,000
2002	\$345,800	\$1,000,000
2003	\$345,800	\$1,000,000

# Gift Tax (slide 1 of 3)

- Persons subject to tax:
  - Citizens or residents of the U.S. on all transfers by gift of property wherever located
  - Nonresident aliens, if the gifted property was situated in the U.S.

# Gift Tax (slide 2 of 3)

- Requirements for a gift:
  - The donor is competent to make the gift and the donee is capable of receiving and holding the property
  - Donative intent of the donor
  - Actual or constructive delivery of property to donee or donee's representative and acceptance of gift by the donee

# Gift Tax (slide 3 of 3)

- A transfer is not a gift if the transfer is incomplete
  - e.g., Funds may be transferred to a trust
    - If terms of the trust allow the transfer to be revoked for any reason, the transfer is not a gift

# Excluded Transfers

- Federal gift tax does not apply to:
  - Transfers to political organizations
  - Tuition payments made to an educational organization on another's behalf
  - Amounts paid on another's behalf for medical care

# Annual Exclusion

- The first \$11,000 of gifts made to any person during any calendar year is excluded in determining the total amount of gifts for the year
  - Applies to all gifts of a “present” interest
- Spouses may elect to “split” gifts
  - e.g., Allows one spouse to give \$22,000 to each donee during a year, even if the assets were only owned by one spouse. Allows gift to be treated as being made 1/2 by each spouse eliminating any transfer tax on the gift

# Gift Tax Example

(slide 1 of 4)

- During the current year, Jane and Harry, a married couple, make the following transfers in 2003:
  - \$22,000 cash to son Hal
  - \$20,000 tuition for daughter Beth
  - \$60,000 to the American Diabetes Foundation, a qualified charity
  - \$10,000 to the “Young for Governor” campaign
  - \$200,000 to a revocable trust for the benefit of their two children
  - \$30,000 for medical care and medical insurance for Jane’s mother
  - \$60,000 car to Harry’s brother, subject to a liability of \$30,000

# Gift Tax Example

(slide 2 of 4)

- Which of these transfers are treated as gifts for gift tax purposes?
- What is the amount of taxable gifts for the year if Jane and Harry elect to split gifts?

# Gift Tax Example

(slide 3 of 4)

- Several of these transfers are not included in gross gifts:
  - The \$20,000 tuition payment, \$30,000 medical care and \$10,000 political contribution are not gifts by definition
  - The \$200,000 transfer to the trust is not a completed gift since the trust is revocable
  - The car transferred to Harry's brother is 50% a sale for \$30,000 (amount of liability) and 50% a gift of \$30,000. Harry may have taxable gain (for income tax purposes) on the \$30,000 sale

# Gift Tax Example

(slide 4 of 4)

## Taxable Gifts calculation:

Cash to Charity	\$60,000
Cash to Hal	22,000
Car to Harry's brother	<u>30,000</u>
Total gross gifts	\$112,000
Less: charitable deduction	(60,000)
Less: annual exclusion (\$11,000 each for Harry and Jane, for each donee (Harry's brother and their son Hal))	<u>(44,000)</u>
Taxable gifts	\$ 8,000

# Gift Tax Example #2

(slide 1 of 5)

**Mel (an unmarried individual) made the following transfers during 2003:**

**Child support payment for son Marvin \$ 25,000**

**Qualified transfer in trust for Marvin, age 12  
(Marvin has no access to the funds until he is 21,  
but funds may be used on his behalf) \$950,000**

**Transfer of stocks to an irrevocable trust. Mel  
retains the income for his life. His mother will  
receive the principal on Mel's death. Assume  
the income interest value is \$130,000 and the  
remainder value is \$70,000. \$200,000**

# Gift Tax Example #2

(slide 2 of 5)

- Mel made prior taxable gifts of \$750,000 and paid \$248,300 tax
- What is Mel's 2003 gift tax liability?

# Gift Tax Example #2

(slide 3 of 5)

## Taxable gifts in 2003:

Transfer in trust for Marvin	\$950,000
Transfer in trust for mother	<u>70,000</u>
Total current taxable transfers	\$1,020,000
Less: annual exclusion	<u>-11,000</u>
Current taxable gifts	\$1,009,000
Prior taxable gifts	<u>750,000</u>
Total taxable gifts	\$1,759,000

## Tax Liability:

Tax on taxable gifts	\$672,350
Less: Prior gift tax paid	248,300
Less: Unified credit	<u>345,800</u>
Net Tax Due in 2003	\$ 78,250

# Gift Tax Example #2

(slide 4 of 5)

- Comments regarding gift tax calculation:
  - Child support payments are not a gift for gift tax purposes in most cases
  - The transfer in trust for Marvin qualifies as a present interest under §2503.
    - The \$11,000 annual exclusion is available for this transfer

# Gift Tax Example #2

(slide 5 of 5)

- The transfer in trust for Mel's mother is a completed transfer since the trust is irrevocable
- Only the remainder interest is a gift since Mel keeps the income interest for his life
- This is a gift of a future interest
  - The \$11,000 annual exclusion is not available

# Formula for the Federal Estate Tax

Gross Estate

- Deductions

(expenses, indebtedness, taxes, losses, charitable bequests, and marital deduction, family business)

Taxable Estate

+ Taxable Gifts

Made after 1976

= Taxable Transfers

Tentative Transfer Tax

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Including the unified tax credit

= Estate Tax Due

On Taxable Estate

# Gross Estate (slide 1 of 3)

- The Gross Estate includes all assets owned by the decedent at their FMV, including the following:
  - Personal effects, jewelry, furniture
  - Stocks, bonds and other investments
  - Rights to receive dividends or interest (if accrued at the date of death), and
  - The value of businesses owned by the decedent

# Gross Estate (slide 2 of 3)

- The Gross Estate includes the proportionate value of any asset owned by a decedent and another person, if both parties paid
  - e.g., A decedent jointly owns a boat with his son. Both parties paid one-half the initial purchase price.
    - Only one-half the value of the boat is included in the Gross Estate

# Gross Estate (slide 3 of 3)

- Asset values are determined at:
  - The date of death, or
  - The alternate valuation date (AVD), 6 months later, if elected by the executor
    - AVD must reduce gross estate and estate tax liability if used

# Adjusted for Gifts Within 3 Years of Death - §2035 (slide 1 of 2)

- The Gross Estate includes any gift tax paid on gifts made within three years of death
  - Called the *gross-up* procedure
  - Prevents the gift tax amount from escaping the estate tax

# Adjusted for Gifts Within 3 Years of Death - §2035 (slide 2 of 2)

- The Gross Estate also includes the following assets if gifted within three years of death:
  - Transfers of property if decedent originally retained right to use the property for life
  - Transfers of property which the transferor may revoke, even if the transferor waives the revocation ability within three years of death

# Deduction For Qualified Family-Owned Businesses (slide 1 of 3)

- To provide limited tax relief for small businesses, a deduction of up to \$675,000 is allowed for qualified family-owned business interests (QFOBI)
  - Applies to estates after 1997
  - Exclusion is tied to the exemption equivalent
    - Total of the two cannot exceed \$1.3 million

# Deduction For Qualified Family-Owned Businesses (slide 2 of 3)

- Only applies when value of business interest exceeds 50% of adjusted gross estate

# Deduction For Qualified Family-Owned Businesses (slide 3 of 3)

- To ensure that the business is operated by the decedent (or family):
  - Decedent (or a family member) must have owned and materially participated in the business for at least five of the last eight years
  - Qualified heir must materially participate in the business for at least five years in an eight year period during 10 years following the decedent's death

# Gross Estate Example

(slide 1 of 5)

- 1. Marcia owned a \$100,000 life insurance policy on her son George's life. The cash surrender value (CSV) of the policy was \$25,000 when Marcia died this year.
- 2. George purchased and owned a \$100,000 life insurance policy on Marcia's life (his mother), which he collected when Marcia died

# Gross Estate Example

(slide 2 of 5)

- 3. For \$30,000, Marcia purchased \$100,000 of insurance on her life. She gave this policy to her husband Milford four years before she died.
- 4. For \$35,000, Marcia purchased an additional \$100,000 of insurance on her life. She gave this policy to son George one year before she died, and paid gift tax of \$5,000 on the transfer.

# Gross Estate Example

(slide 3 of 5)

- 5. Marcia and son George jointly owned real estate valued at \$600,000. Marcia paid \$45,000 of the original cost and George paid \$15,000.
- 6. Marcia and husband Milford jointly own additional real estate valued at \$1,200,000. Milford paid the entire \$680,000 purchase price. (Assume this is not community property).

# Gross Estate Example

(slide 4 of 5)

- 7. Marcia established a revocable trust with son George as remainder beneficiary. The value of assets was \$60,000 when the trust was created and \$200,000 when Marcia died.
- 8. Marcia owned a vacation residence and transferred title to George six years ago, but she (and Milford) continued to use the property valued at \$500,000 each summer. (No one else uses the property.)

# Gross Estate Example

(slide 5 of 5)

- 9. Marcia and Milford jointly own cash, stocks, personal effects and other real estate valued at \$2,000,000.
- 10. Marcia has a life estate in a trust created by her father's will. Son George is the remainder beneficiary. The value of trust assets is \$1,250,000. Marcia has an income interest and can use trust assets for her support, health, education, or maintenance.

# Marcia's Gross Estate

(slide 1 of 5)

- 1. \$25,000 CSV is included. This is insurance on another person's life, and is not matured, so its only value is the replacement cost, or the cash into which the policy can be converted. (George is still alive, so Marcia's estate does not have access to \$100,000, it can only receive \$25,000 if it cashes in the policy on George.)
- 2. \$ -0- is included, since George bought and owned the policy.

# Marcia's Gross Estate

(slide 2 of 5)

- 3. \$ -0- is included, since this policy was gifted more than three years prior to Marcia's death (also, marital deduction would apply if included).
- 4. \$105,000 is included: the value of the life insurance plus the \$5,000 gift tax since the transfers were less than 3 years before death. (The estate will get credit for the \$5,000 gift tax paid.)

# Marcia's Gross Estate

(slide 3 of 5)

- 5. \$450,000 is included since Marcia originally paid 75% of the cost. Note that Marcia made a \$15,000 gift when they bought the property. Assume gift splitting was used and no tax was paid at that time.
- 6. \$600,000 is included. One-half the value of property held jointly by spouses is included regardless of who purchased the property.

# Marcia's Gross Estate

(slide 4 of 5)

- 7. \$200,000 is included. The trust was revocable so it is Marcia's property.
- 8. \$500,000 is included since she retained the right to use the property.
- 9. \$1,000,000, or one-half the value of these jointly held assets, is included in Marcia's gross estate.

# Marcia's Gross Estate

(slide 5 of 5)

- 10. \$ -0- is included since Marcia does not have a general power of appointment over these assets. Her rights to the income of the trust terminate at Marcia's death. Note: if the trust has accrued income which is rightfully Marcia's at her death, that amount should be distributed to her estate and included in the gross estate.
- Total Gross Estate: \$2,880,000

**If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:**

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