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Overview of The Gift Tax / Estate Tax System

for Married Taxpayers

As a result of *The American Taxpayer Relief Act of 2012* ("ATRA") the amount of the estate tax exemption for decedent's dying in 2013 is $5,250,000 (potentially $10.5 million for a married couple.) That exemption amount is now indexed for inflation, and will increase somewhat from year to year. As a result, most people will now be able to address their estate planning goals without concern for the cost imposed by the federal estate tax. (See the article titled "The Estate Planning Process" on this web site.)

Although we talk about the *Gift Tax* and the *Estate Tax* as if they were separate tax systems, they are actually parts of a *unified transfer tax system* (which also includes the *Generation Skipping Transfer Tax* mentioned below.) That is, the total amount of transfer tax ultimately paid is computed on the aggregate amount of all taxable gifts which one makes during life and the size of the taxable estate remaining at one's death. Therefore, if John Doe has an estate of $7,500,000, he may transfer part of it by gift during his lifetime and the rest by his estate at his death. However, the ultimate tax liability will be computed on the full $7,500,000 regardless of when it is transferred. That result is affected by computing the estate tax due at death as follows:

1. Determine the value of the estate remaining at death; and
2. Add thereto the amount of all taxable gifts made during life (after 1976); and
3. Compute the tax on the total amount (at a rate of 40% after taking account of the available exemptions discussed below;) and
4. Subtract the amount of any tax actually paid on the taxable gifts made during life.

As a result of this "*unified tax system*" approach, the making of taxable gifts does not reduce the total amount of tax paid except in the following few circumstances.

First, there are certain *exemptions* and *deductions* available under the gift tax laws which allow some gifts to be totally removed from the taxable estate, as discussed below.

Second, a gift of property will also transfer to the recipients all future appreciation and income on the transferred property and prevent those increases in value from being in the donor's estate, as discussed further below.

Third, certain types of lifetime transfers provide substantial *leverage* because they remove more value from the taxable estate than the amount of the gift which the donor recognizes under the gift tax law. (See article titled "*Discounts and Leverage Transactions*" on this website.)

Exemptions and Deductions - There are some valuable exemptions and deductions available in the gift tax and estate tax arena. Much of estate tax planning, in fact, revolves around maximizing the use of these exemptions and deductions, which are generally summarized as follows:

Annual Gift Tax Exclusions - Each donor of a gift is allowed to give up to $14,000 (in 2013) per recipient, in each calendar year, to as many different people as he or she wishes. Such gifts may be in cash or property, and are completely removed from the computation of the donor's taxable gifts and taxable estate. Therefore, to the extent one is willing currently to part with the assets and give them to other family members, this exemption permits one to do so with no gift tax or estate tax liability. For example, if a donor has three children and six grandchildren, he or she could make annual gifts (each calendar year) totaling $126,000 ($14,000 x 9 recipients) free of any gift tax or estate tax consequences. The amount of the annual exclusion is indexed for inflation, and will increase in $1,000 increments over time.

Gift Splitting - In addition, a married couple may agree to "pool" their exemptions and allow either spouse to give up to $28,000 per year to any recipient. That is, Husband could give up to $28,000 of his assets to each of their three children and six grandchildren (a total of $252,000) annually, and Wife could allow him to use her $14,000 annual exclusions along with his own. This "pooling" of the exclusion is referred to as "gift splitting" because the spouses agree to "split" the gifts made by each of them and treat the gifts as if one-half was made by each spouse. Gift splitting requires the express consent of the spouses on a properly filed gift tax return (Form 709) even though no tax is due.

Marital Deduction - For both gift tax and estate tax purposes, all transfers from one spouse to the other are free of any transfer tax, with no limitation as to amounts. In effect, the transfer tax system treats the "marital unit" as a single taxpayer, and all transfers within the marital unit are exempt from any tax. There are some limitations as to the manner in which these spousal transfers must be structured in order to be exempt. They can generally be either outright transfers to the recipient spouse, or transfers in trust where the recipient spouse has the exclusive right to the income from the trust for life. [Note that there are additional special rules which apply to qualification for the marital deduction where the recipient spouse is not a U.S. citizen.]

Charitable Deduction - For both gift tax and estate tax purposes, all transfers to qualified charitable organizations are exempt from tax, with no limitation as to amounts. The "qualified charitable organization" can be a public charity (one's favorite school, etc.) or a charitable entity created by the donor (a charitable trust, family foundation, etc.) Note that this deduction for gift tax and estate tax purposes is in addition to any income tax deduction to which one might be entitled for charitable gifts.

The Unified Credit (Exemption) - Every taxpayer is entitled to an "exemption" for certain amounts of taxable gifts and/or a certain amount of taxable estate value at death. As a result of ATRA the amount of the estate tax exemption for decedent's dying in 2013 is $5,250,000. That exemption amount is now indexed for inflation, and will increase somewhat from year to year.

The available exemption is applied first to offset any tax payable on lifetime taxable gifts. (Note that, unlike prior years, the full $5,250,000 is available for gifts.) Then, at death, as explained in detail at the beginning of this article, those lifetime "adjusted taxable gifts" are added back to the estate value remaining at death to compute the gross estate tax due, and the full exemption (indexed for inflation to the year of death) is then applied to the tax on the full "grossed up" amount of taxable transfers.

In addition, there is now some "portability" of the unused exemption amount from a decedent to his or her surviving spouse. Therefore, for persons who do not engage in estate planning for the effective use of that exemption, the first deceased spouse's unused exemption can pass to the surviving spouse, who will be able to use the full amount in his or her later estate. For example, assume that H dies in 2013 with no effective tax planning in place, leaving his entire estate to surviving W. There will be no estate tax payable in H's estate (because of the marital deduction,) and upon W's subsequent death her estate may be able to use both her exemption (the amount indexed for inflation to her year of death) and H's unused $5,250,000 exemption, for a possible total in excess of $10.5 million of exempt property.

In most cases, portability is not a substitute for effective planning to optimize the use of the exemption, but this is a great improvement in the treatment of estates of decedents who have not taken time to implement such planning. There are some limitations to the value of this portability benefit:

- It is available only where the estate of the first deceased spouse files a Federal Estate Tax Return, even if that return would not otherwise be required because the size of the estate was less than the exemption.
- It can be lost if the surviving spouse remarries.
- It applies to preserve the first deceased spouse's estate tax exemption, but does not preserve the first deceased spouse's unused generation skipping tax exemption, which may be very important if an objective is to protect the assets for the children and later generations. (See article titled "*Multi-Generation Planning*" on this site.)
- While the property in the hands of the surviving spouse may increase in value over time, the "portable" exemption amount from the first deceased spouse is not indexed for inflation and does not grow.

- It is troublesome in blended families (where the beneficiaries of the surviving spouse may be different from those of the first deceased spouse), and in young families (where one would expect the surviving spouse to remarry and have a new spouse, and perhaps children, who were not the beneficiaries of the first spouse.) In these situations, there is no assurance that surviving spouse will use the first deceased spouse's exemption the benefit the first deceased spouse's preferred beneficiaries.

- Unlike a trust, it does not provide a means for the surviving spouse to transfer taxable income (and the income tax liability) to lower-bracket family members (children and grandchildren) to reduce overall income tax costs.

Portability does offer some distinct advantages in other circumstances:

- It allows a second income tax basis "step up" at the death of the surviving spouse (see discussion below under "The Income Tax Cost of Making Gifts.")

- It facilitates optimizing the tax benefits of qualified retirement plan assets (IRAs, 401(k) plans, pension and profit sharing plans).

Transfer of Income and Appreciation - The transfer of a gift (to an individual or a trust) will generally cause future income flowing from the gifted property and future appreciation in value to be removed from the donor's taxable estate. In addition, where the recipients are in a lower income tax bracket, a substantial reduction in the family's overall income tax burden may be realized.

Income - After ATRA, there can be a much larger gap between the income tax brackets of estate owners and the brackets applicable to their family members. For estate owners with taxable income in excess of $400,000 ($450,000 for joint returns), the marginal tax bracket (federal + state + Medicare surtax) will now reach about 47% on ordinary investment income and about 27.4% on long term capital gains and qualified dividends. For younger family members those tax rates may typically be between about 20% and 32% on ordinary income, and between 6% and 20% on long term capital gains and qualified dividends. If the estate owners are expending income for the support and education of those younger family members, then giving to a trust for the young family members the property which produces that income could result in substantial income tax savings over the years.

Appreciation - Our transfer tax system is very efficient in capturing a tax on the transfer of wealth in the form of property. However, it is not effective in taxing a transfer of opportunities to realize wealth from the ownership of property. A common example arises when the family is considering an opportunity for development of property. A gift of an interest in that property before development will be valued based on the current fair market value of the land. After development, however, it is anticipated that the value will be much greater. A properly timed gift (or sale) of the property may transfer the appreciation out of the family's taxable estate with no current tax cost. Similar opportunities occur frequently when a family-owned business is considering either a sale or "going public."

The Income Tax Cost of Making Gifts. It is also important to recognize that some gifts can result in substantially more overall tax liability in the family than simply keeping the property and including it in the taxable estate. In general, property which is included in one's gross estate at death receives a "stepped up" income tax basis in the hands of the beneficiaries, equal in amount to the value of the property at the decedent's death. Even if the decedent had a very low basis during life and would have faced a substantial income tax on the capital gain resulting from a sale of the property, the estate or its beneficiaries can sell the asset after the taxpayer's death at that date of death value with no income tax cost.

For instance, if W owns a share of stock which cost $1.00 and has a market value of $20.00, W would pay income tax on a $19.00 capital gain if she sold it during her life. However, if W dies owning that stock, the stock is included in her estate at its $20.00 market value for estate tax purposes, and the estate's income tax cost basis is adjusted upward to that $20.00 value (even though there may be no estate tax payable.) The estate or its beneficiaries could then sell the stock for $20.00 and recognize no capital gain.

However, property transferred by gift during W's life retains her basis for income tax purposes. If W were to give that share of stock to her children at its current $20.00 market value, she would be treated as having made a gift of $20.00 for gift tax purposes, but the children would retain W's cost basis of only $1.00. If they then sold the stock, they would pay income tax on the $19.00 gain. Consequently, lifetime taxable gifts of low-basis property may not remove much taxable value from the "unified" gift tax and estate tax system, and could cost the family a basis step-up at death. The result might well be an income tax cost which far exceeds any gift tax or estate tax savings.

The Generation Skipping Transfer Tax. In addition to the Gift Tax and the Estate Tax, the unified transfer tax system includes a tax imposed on certain "generation skipping" transfers. See the article titled "*Multi-Generation Planning*" on this web site for a description.

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