

Estate Tax

The purpose of this article is to explain the U.S. transfer tax system in a way that it can be understood by a nonprofessional. I have purposely been vague about effective dates, rates, and tax computations because my purpose is to provide only a basic understanding of this tax and how it works. It is by no means suitable for use as a "do it yourself tool."

I always recommend seeking professional help when preparing or acting on an estate plan. Whether you use our firm or another, it will be money well spent.

Since the 1970's we have had a "unified" Estate and Gift tax that applies to transfers of property over the taxpayer's entire lifetime. This tax is always levied on the transferor. There is no "inheritance tax."

For gifts made *during the taxpayer's lifetime*, gift tax rules apply and gift taxes are paid. For bequests that result in a *post death transfer*, estate tax rules apply.

We called this tax the "unified estate and gift tax" and the credit against it as the "unified credit". Until 2002 the taxable amount, the rate of tax and the credit were identical even though gifts are reported on form 709 "Gift Tax Return" and estate transfers were reported on form 706 "Estate Tax Return,"

In 2002, the credit against the estate tax began scheduled increases that will culminate in the elimination of the estate tax in 2010... for one year. In 2011, unless legislation changes, the estate and gift tax credits will once again be identical and the estate tax will apply to all taxable estates.

I have attached a table of the scheduled changes in estate tax credit. It is helpful to remember that there is really no "exemption" from estate or gift tax, only the credits. There is, however, an "annual" exclusion of \$12,000 in 2008 per taxpayer, per donee. Transfers during the lifetime of the transferor are subject to the annual exclusion. The annual exclusion increased to \$13,000 in 2009.

Simply put, all estate tax planning utilizes the annual exclusion and the credits (formerly "unified credit"). When utilizing lifetime giving to reduce or avoid estate tax, we have enough credits for \$1 million in lifetime transfers per taxpayer; \$2 million for a married couple with a properly drafted and funded living trust.

Upon death, the estate tax applies. Effective 2004, the credits available against the estate tax exceed credits available for lifetime gifts. As shown on the table, these credits will increase

through 2009 to cover a \$3.5 million estate (\$7 million for a married couple with proper estate planning documents). Since we are limited to \$1.5 million (in 2004) over an entire lifetime, the valuation of transferred assets is a key issue.

Since the credits against the estate tax are scheduled to increase over the remainder of this decade culminating in the elimination of the tax for *one year in 2010*, most lifetime gifting strategies must be considered very carefully. If the estate tax is eliminated, there is really no down side to prior lifetime gifts as long as no gift tax was paid. However, if the estate tax is not permanently eliminated and the credit against the estate tax remains greater than the credit against the gift tax (see table for years 2004 through 2009), lifetime gifts may result in greater income or capital gains to the transferee than would have been in the case if the transfer had occurred after death and, by virtue of the larger credit, no tax would have been paid.

Why do wealthy taxpayers make gifts during their lifetime?

Once an estate gets to a size that it creates more new wealth annually than the taxpayer can (or chooses to) consume, the estate generally increases *at an increasing rate*. Since transfer tax rates have historically exceeded 50%, many wealthy taxpayers try to accomplish an "estate freeze" by moving appreciating assets out of their estate into the estate of their heirs or to a charitable institution that can pay the donor income. Most of these estate freeze techniques involve gifting of assets during the transferor's lifetime.

Valuation of Assets Transferred

For the Gift tax, **the donor's basis** is the basis to the *recipient*. This is known as "*carryover basis*." However, the fair market value on the date of the gift is the amount used to value the gift for gift tax purposes. Thus, the transferor must use fair market value in computing the gift tax, but the recipient must use the transferor's basis when selling an asset acquired by gift.

For Estate tax, the donor's basis is ignored **and the donee values the asset at the fair market value on the date of death**. This is known as "*stepped up basis*" Fair market value is used in calculating the amount of wealth transferred at death.

Thus an immediate sale of an asset received via gift is likely to generate a tax liability (at capital gains rates) whereas a sale of an asset received by inheritance will likely not generate an income tax liability since there would be no taxable gain due to "step up in basis."

Unlimited Marital Deduction:

When a married taxpayer passes away his/her entire estate passes to his/her spouse, *estate tax free*. This is called the "Unlimited Marital Deduction." If the couple had a community property agreement (usually part of a living trust) all the community property steps up to fair market value as of the date of death. Absent the community property agreement, the portion belonging to the decedent steps up and the balance remains at original basis.

Discounted

Values:

One of the methods we use to gift large portions of estates without paying gift tax is to utilize gifts of partial interests without control. By using such means we can generally discount the "pro rata value" of the gifted asset up to 30% and more. Thus a transferor could transfer an asset worth \$1 million and only report a taxable gift of \$700,000. Since credits cover the first \$1 million in taxable gifts, no tax would be payable in this illustration.

The logic behind discounted value:

1. A owns real estate with a market value of \$1 million. A can sell his real estate when and to whom he chooses. No discount; no lack of control or marketability.
2. A & B own the same real estate in example 1 in equal shares. A wants to sell B doesn't want to sell. Thus, the only way for A to sell is to sell to B. B knows A has no choice, so he is likely to *offer less* than \$500,000. Thus, the concept of "lack of control" discount.
3. A owns the same \$1 million real estate parcel. Pursuant to an estate plan, he gifts 12% interests to each of his four children. A and his children then transfer their undivided interests into a Family Limited Partnership. A retains control as general partner. The value of the gifts of undivided interests are discounted for lack of control and lack of marketability by approximately 30% thus the gift value is \$84,000 ($\$1,000,000 \times .70 \times .12$). In subsequent years, A can utilize the discounted value of the limited partnership interest he retains. Assuming he formed the partnership owning a 1% general partnership interest and a 51% limited interest, he can gift limited partnership interests utilizing his annual exemption amount of \$13,000 for each child $\$13,000 \times 70\% = \mathbf{\$18,590}$. Thus each year A can gift away an additional 2.2% of his property ($\$18,590 / \$700,000 = .02245$) to his children, gift and estate tax free while retaining complete control of the property as general partner by using the annual exclusion and applying the discount.

There are myriads of rules and pitfalls; experienced professional assistance should be engaged before adopting any strategy involving lifetime *gifting* and/or discounts. Some lifetime gifting methods utilizing discounts will be explored later in this document.

For quick questions on this subject, to suggest a new topic for an overview paper, or more information on how Polito Eppich can help you make the right choices for your circumstances, please contact Paul Polito (pmp@politoeppich.com) or Don Eppich (dpe@politoeppich.com) at 760-599-9900.