FEDERAL TRANSFER TAXES & THE UNIFIED CREDIT
(WITH A MENTION OF CAPITAL GAINS)

<u>*DISCLAIMER*</u>
This article is intended for informational purposes, only. It does not constitute legal advice. Nor is it a substitute for legal advice.

In the United States we have transfer taxes. These are taxes imposed on the value of property that is given away, i.e. gratuitously transferred. If the gratuitous transfer is made during life, it is called a gift; if it is made at the time of death, it is generally called a bequest or devise. The tax on property transferred as a gift during life is called the **gift tax**. The tax on property transferred at the time of death is called the **estate tax**. Each of these taxes is imposed at a rate of 40%. The idea is to tax transfers of property at each generational level for the social purpose of preventing the concentration of wealth in too few hands. (One might question whether these taxes are accomplishing the stated purpose.) There is a third transfer tax called the **generation-skipping transfer tax**, or GSTT. Congress enacted the GSTT to prevent people from making an end run around the estate tax by leaving property to grandchildren and great grandchildren.

Most Americans (and their estates) will not pay any transfer tax. This is because of something called the **unified credit**. To put it simply, each citizen has a credit under our tax laws that they may use to exempt assets from transfer taxes. How much is that credit worth? In other words, how much can be exempted from transfer tax using that credit? (This exempt amount is technically known as the **applicable exclusion amount**.) The answer to that question, which for several years has been a moving target, has now been answered "permanently" – we are told – at $5 million per person.[1] The Taxpayer Relief Act of 2012 fixed the applicable exclusion amount at $5 million per person permanently indexed as of 2011, so that, as of 2015 that amount is $5.43 million. If your estate is worth less than $5.43 million at the time of death, it is unlikely that any estate tax will have to be paid.

The unified credit may be used to exclude both gifts from the gift tax and time-of-death transfers from the estate tax. The unified credit is, however, cumulative. If you give away $1 million in property while you are alive, and exempt that $1 million transfer from gift tax by using your credit, you will have $4.43 million of credit remaining. In other words, it is a single, life-time credit. It can also be used where needed to exempt transfers from the GSTT. Let's start with the estate tax.

<u>Estate Tax</u>

<u>The Estate</u>
What is the estate upon which the estate tax is imposed? What is the estate made up of? It is important to understand that a person's taxable estate is often not the same thing as

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[1] It seems only prudent to take *permanent* with some salt given the extent of political disagreement over the $5 million figure.

their probate estate.[2] In fact, a person may have planned their estate in such a way as to avoid probate, but that person may still have a large taxable estate. In general, for estate tax purposes, the estate is made up of all property to the extent the deceased person had any interest in the property. If the deceased person owned it at the time of death, or had an interest in it, it is likely part of his or her taxable estate. This includes property that is held in a revocable trust, or property that is subject to payment on death (or beneficiary) designations.[3] IRAs are included in taxable estates. Without attempting to explore all the types of property interests that are included in a person's taxable estate, and bearing in mind that there are qualifications to each of these categories, let's list some:

- Property transferred with strings attached. For example, if a parent, during life, deeds away their land to a child but retains a life estate under which the parent remains legally entitled to control and enjoy the property for the duration of life, the value of that property in general will be included in the parent's taxable estate.[4] (For more information on titling of assets and future interests, see article on *Titling*.)

- The value of joint tenancy property. For example, if a parent, during life, deeds land into joint tenancy with an adult child, and the child paid nothing for the land or for any improvements on the land, then the value of that property in general will be included in the parent's taxable estate upon death. The rules are different for spousal joint tenancy property (property which spouses own jointly), where, generally, half the value is included in the estate of the first spouse to die.

- The value of certain annuities (or other payments) under which beneficiaries are paid as a result of the death of the owner of the annuity.

- Life insurance proceeds (the death benefit amount). If the deceased person owned the life insurance policy at the time of death, the death benefit amount is included in his or her taxable estate. (If a person transfers ownership of a life insurance policy within three years of death, it is still part of his or her taxable estate.) If the life insurance death benefit amount is payable to the deceased person's executor, even though the deceased person did not own the policy at the time of death, it will likely be included in the taxable value of the estate.

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[2] See *Probate* article. By way of a simple example, a person's real estate may be transferred to his or her heirs by Will through a probate proceeding in county court, and so be part of the probate estate. That same person may have owned checking or mutual fund accounts for which they filled out papers directing that the money in the account at the time of death go to their heirs. The funds in those accounts would then transfer to the heirs not through the probate but through those papers (called beneficiary designations). Those funds would, however, remain part of the person's taxable estate.
[3] Separate articles are available on *Trusts*, on *Beneficiary Designations* (including an article on Nebraska's newly enacted Transfer on Death real estate deeds, also called beneficiary deeds.)
[4] Note that the deceased person had transferred ownership of the property prior to death (maybe many years prior to death) and so did not own the property at the time of death. But the retention of the life-time right to use the property meant that the child did not acquire economic value from the property until the time of the parent's death.

- Certain education savings accounts and distributions from qualified tuition programs.

The value of property which the deceased person gave away within the three years that preceded his or her death is <u>not</u> included in the gross estate. However, this rule is subject to important exceptions, such as the life insurance exception. Consider our life estate example, where the parents deeded land away to child but kept life time use. Assume that one of the parents, the father, has died. If the surviving parent, the mother, transfers away her life estate within three years of her death, the value of that property would still be included in her gross estate. In general, if the deceased person had transferred property revocably (as in a revocable "living" trust, for example), or, if the transfer was irrevocable but the deceased person had retained a lifetime use, and then, within three years of death, the deceased person gave away their retained interests (made the prior revocable transfer irrevocable, or transferred away by gift the life use), the value of that property would still be included in the taxable estate. It is perhaps simplest to understand these exceptions by considering this example. Let's say a person sets up and funds a revocable trust. They now own their estate inside the trust. The trust is revocable, meaning that person can undo it or change it at any time. Now imagine that that person in the contemplation of impending death makes the trust irrevocable – cuts all ties to the trust property – and then dies, perhaps a week later, having thought to exclude the property in trust from the taxable gross estate. The three-year exception prevents this kind of planning, and pulls such transfers into the gross estate.

Transfers within the three year period preceding death can also affect special use valuation eligibility. (See article on *Special Use Valuation*.)

To summarize, generally: if the deceased person at the time of death owned property, or had an interest in it, the value of that property is likely to be included in the taxable gross estate; if it is property – or an interest in property - which another person will receive or enjoy only by reason of the deceased person's death, that is by surviving the deceased person, it is likely to be included in the gross estate. And the value of certain transfers within three years of death, as discussed, may become part of the gross estate. As is probably clear, some of the rules for inclusion and exclusion of property in a taxable estate may become quite complex.

<u>Deductions</u>
There are deductions which reduce the taxable size of the gross estate. They include funeral expenses, administrative expenses (such as the costs associated with administering the estate, i.e. attorney fees, and personal representative fees), claims against the deceased's estate (debts that have to be paid), mortgages against estate property and losses. There is a deduction for transfers for public, charitable or religious uses: the value of property given to a qualifying charity is not taxed. There is also an important deduction for transfers to a surviving spouse. This is called the **marital deduction**. It basically means that any property of any value being left to a surviving spouse is removed from the taxable gross estate. In general, spouses can transfer any amount of property to one another whether by gift or at the time of death and no transfer

tax will be paid on that transfer. This is an important aspect of tax law in much estate planning.

Valuation

How is the taxable gross estate valued? All property is valued, whether real or personal, tangible or intangible, wherever located, as of the date of death of the owner. It is possible to choose an alternative valuation date, typically six months after the date of death, but whichever valuation date is selected it applies to all property of the estate. Valuation can be difficult – a moving target. A discussion of all the ins-and-outs of valuation is beyond the scope of this article, but we will try to hit the high points.

Valuation is generally for fair market value, that is, the amount that property would sell for between a willing seller and a willing buyer. Most valuations are determined by qualified appraisal. Some values have to be determined actuarially. For example, if the deceased person was entitled to receive payments for a period of years, which someone else will now receive, what are those payments worth at the time of death? Or if the deceased person left a life estate to his or her surviving spouse, with the remainder interest going to the children, what is the value of that taxable remainder interest relative to the spousal life estate for which there is a marital deduction? There is a special valuation method for qualifying family farms. (See article on *Special Use Valuation*.) Some property may be subject to certain discounts in value for tax purposes, such as minority, lack-of-control, marketability, blockage, or other discounts. In some cases, there may be discounts available for built-in capital gains, i.e. for the capital gain tax that would have to be paid should the property be sold.

Basis Adjustment & Capital Gain

The valuation of an estate may be important for another tax reason, separate from transfer tax, namely capital gain tax. In general, by way of a very simplified background, gain realized from the sale of property is generally included in gross income and subject to taxation. How is gain measured? It is the excess of the sale price over the **basis** of the property in the hands of the seller. An example will illustrate. If you buy a parcel of land for $1000 per acre, your basis in the land is $1000 per acre. Basis is a tax term for cost. If you sell that parcel of land for $5000 an acre, you will have realized gain in the amount of $4000 per acre and you can expect to have to pay capital gain tax on that gain.[5] If you do not sell that piece of land, you will not pay tax on the gain. The gain, however, will remain built-in to the land, springing to taxable life should it ever be sold. What happens if, instead of selling the land, you give it away? The answer depends on whether you give the land away as a gift or as a bequest – during life or at death. In general, in a gift, the basis in the hands of the recipient is the same as the giver's basis. So, if you give away that parcel of land, the person you give it to will have a $1000 per acre basis in the land. If he or she should sell it for $5000 per acre, capital gain tax will be paid on the $4000 of gain. However, if you give that parcel of ground in a bequest, i.e. in a time-of-death transfer, the basis of the property in the hands of the new owner becomes its fair market value at the time of your death. Essentially, the appreciation in the property from

[5] Basis may be subject to adjustment for improvements in the property made by the owner. In general improvements for which a deduction is taken do not increase the basis.

$1000 per acre to $4000 is wiped out for tax purposes by the time-of-death transfer. If the person who inherited the land from you - the new owner - then sells it for $5000 per acre, no capital gain tax is paid. This is generally referred to as a **step-up in basis**, also as a **basis adjustment**. (It is of course possible that the basis could be stepped down at the time of death, for property which has declined in value from the deceased owner's basis.)

The valuation of an estate at the time of death therefore bears directly on the basis which the heir will have in the property. A time of death transfer is the only way to wipe out the taxable appreciation in an asset without payment of capital gain tax.

The estate tax return (Form 706) must be filed within nine months of death, with a possible six month extension. An estate tax return is required only if the deceased person's gross estate is worth more than the unified credit exemption amount – the applicable exclusion amount. A return must be filed if the gross estate exceeds the exemption amount even if no tax is payable after considering the deductions and credits.

Gift Tax

The gift tax is imposed on the value of property given away – gratuitously transferred – during life. Like the estate tax, it is currently imposed at 40%. Also like the estate tax, a person may use their unified credit to exempt the gift from taxation.[6]

It is important to know about something called the gift tax **annual exclusion**. A person can give away each year as much as $14,000 (2015) to as many separate people as he or she likes, without having either to pay any gift tax or to file a gift tax return. In addition, this annual exclusion amount does not use up a person's unified credit. For example, you may give $14,000 to each of your children each year with no transfer tax consequence, nor will your children pay income tax on the gift. However, if you were to give each child in each year any amount over $14,000, you would trigger an obligation to file a gift tax return and the excess over $14,000 would be a taxable gift. So, for example, if you were to give your daughter $20,000 this year, unless you chose to pay gift tax on the $6000, you would decrease your unified credit by $6000.

The annual exclusion is not cumulative, that is there is no lifetime limit on annual exclusion gifts; nor can you store up annual exclusions for use all in one year.

People often ask whether or not the person who receives a gift has to pay tax on that gift. The answer, in general, is no. If you give $14,000 in cash to one of your children, they will not have to pay tax on it. They will not have to report it as income. But bear in mind that this is because the taxes have already been paid on that $14,000. What does this mean? An example will help. After first hearing about the annual exclusion, and the fact that the receiver of the gift need not pay taxes on the gift, a farm couple were struck by

[6] In the recent past the unified credit was not actually unified. For numerous years the credit applicable to gifts was less than the amount that could be used to exempt time-of-death transfers. For example, in 2009, the unified credit amount was $3.5 million per person, but only $1 million of that amount was available for use to exempt gifts from gift tax. Unification of the credit in the future may not be assured.

the idea that they might leave $14,000 worth of grain in the field for their son to harvest. Mom and Dad would not have to pay income tax on the unharvested grain and, apparently, neither would their son. Thinking this too good to be true they asked some additional questions and discovered that their plan was in fact too good to be true. The value of that grain needs to be taxed. Mom and Dad owned the grain. They grew it, they took deductions for the cost of raising that grain as part of their annual tax computation. They need to include the value of that grain in their taxable income. In other words, gifts are not a way to make taxable value disappear. Similarly, there is no basis adjustment in gifts; the receiver of the gift acquires the same basis as the giver had in the property. Capital gain remains built-in to the property, to be taxed on a sale.

A gift must be complete in order to count as a gift for tax purposes: give it away and keep no strings attached. The gift must be a gift of a present interest. Let's look at an example. Let's say that Mom and Dad transferred the farm into an LLC (limited liability company). Mom and Dad own the LLC; the LLC owns the land. Now they start to gift away interests in that company each year to their son in an amount equal to $14,000. Together they are gifting away $28,000 worth of interests in the company to their son each year.[7] Through these gifts, their son is coming to own each year $28,000 worth of interests in the company. In general, what Mom and Dad give away to their son under the annual exclusion before death will not be part of their taxable estate, but only if the gifts they have made to him are complete. Mom and Dad cannot keep all the income from the company when they do not own all of the company. Their son has to receive the benefit of his ownership interests from the time he receives those interests. If he does not, if Mom and Dad continue to receive all the income from the company as if they owned all of the company, even though they have supposedly been giving some of that ownership away to their son, it is likely that the entire value of the company – even those interests they gave away – will remain part of Mom and Dad's taxable estate.

As stated, a gift made within the annual exclusion amount does not require the filing of a gift tax return. A gift made to any one person in any one year in excess of the annual exclusion amount triggers an obligation for the donor to file a gift tax return. However, there may be an advantage in filing a gift tax return even in the absence of a requirement to do so. Assume that an owner of an LLC is giving to her child each year $14,000 worth of ownership interests in the LLC. How can the owner be sure that what she is giving away each year has a $14,000 value for tax purposes? If she files a gift tax return in which she sets forth the value of the gift, the IRS has three years to challenge that valuation. If the IRS does not challenge that valuation within the three year statute of limitations, the question of value is settled. Similarly, as mentioned, gifts in excess of the annual exclusion are taxable. (Such gifts are not taxable if made to charities under the charitable deduction or made to a spouse under the marital deduction.) Gifts in excess of

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[7] In this example Dad and Mom each own interests in the company which they are giving away under the annual exclusion. But even if only one of them owned the property being given away, they could still combine the annual exclusion amounts through something called gift-splitting. The difference is that gift-splitting generally requires that Mom and Dad file a gift tax return, even though no tax would be payable on the annual exclusion amount. In circumstances where the unified credit has been used up, gift-splitting by spouses can reduce the amount of the gift tax.

the annual exclusion amount are included as part of the giver's taxable estate at death, which is how the unified credit gets used. If the gifts were not properly reported to the IRS for the year the gift was made, the valuation of the gift can be challenged by the IRS at the time of death.

There is an unlimited annual gift tax exclusion for gifts made for the benefit of another person directly to an educational institution for tuition or to a health care provider for medical services. This exclusion is available for contributions to 529 tuition programs.

A gift tax return is to be filed annually for any year in which a taxable gift was made. A gift tax return (Form 709) is not required for gifts under the annual exclusion amount, for gifts using the special exclusion for education and health care, for marital deduction gifts to spouses or, within certain conditions, for gifts to charity. If spouses are splitting gifts (see above) a gift tax return is required even though no tax may be due. As discussed, however, there may be compelling reasons to file a gift tax return, even though not required, related to valuation of gifts.

The GSTT

The generation-skipping transfer tax has a reputation for complexity, even treachery. This discussion will be brief, hopefully. As mentioned, the policy behind our federal transfer taxes, the estate and gift taxes, is to impose a tax at each generation on the transfer of assets. In the past, some families made use of trusts to avoid transfer taxes down through time. To simplify, a person would set up a trust and fund it with assets. A transfer tax would be imposed at the time the trust was funded (gift or estate tax, depending on the type of trust) but the funder's unified credit exclusion amount would have been used to minimize if not eliminate payment of the tax. The trust would provide that the funder's children receive a lifetime benefit from the trust, followed by a life time benefit for the grandchildren, and then the great children, etc. In jurisdictions that allowed trusts of perpetual duration, such a trust could transfer large amounts of wealth down through time without subsequent transfer taxation. Congress saw this as an end run around the policy underlying the estate and gift tax and adopted the Generation-Skipping Transfer Tax, or GSTT.

To oversimplify, the GSTT imposes a tax on generation skipping transfers, which is a transfer of income or principal to or for the benefit of a person beyond the next generation, otherwise known in GSTT talk as a *skip-person*. A skip-person is someone related by blood or marriage to the donor and who is one or more generations removed. Children are not skip-persons; grandchildren, great grandchildren, etc. are. A transfer to a child is not generation skipping; a transfer to a grandchild or great grandchild is. Gifts or bequests made to skip-persons that are above the unified credit annual exclusion amount are subject to the GSTT. (If a grandchild's parent dies before the grandparent, the grandchild moves up a generation for tax purposes and is no longer a skip-person. A trust can be a skip-person if the beneficiaries of the trust are skip-persons.)

An important thing to realize about the GSTT is that the exemption amount – the amount that a person can exempt from generation-skipping tax - is the same as the unified credit exclusion amount. A person is not given one unified credit to use for estate and gift taxes and another to use for GSTT. There can be distinct advantages, however, in allocating some of the unified credit exemption amount for use against GSTT. Let's take a simple example.

Assume Dad and Mom planned on transferring their estate directly to their children using their unified credits to exempt that transfer from transfer tax. Their children would then become the owners of that estate upon Mom and Dad's deaths. That estate, what had been Mom and Dad's property, now owned by their children, would be subject to federal transfer taxes again at the time of the children's deaths. If the children's unified credits are insufficient to protect the full value of their estates, tax will likely have to be paid, thus decreasing the value of the estate. Mom and Dad could instead decide to transfer their estate into a trust for the benefit of their children. The trust would be structured to provide that the children receive income and principal from the trust as needed, but that the children would never become the owners of the trust property for estate tax purposes. Thus any trust property remaining at the time of the children's death would transfer to the grandchildren free of estate or generation skipping taxes.

There are indeed complicated rules under the GSTT for allocating the exemption amount, assigning persons to generations, computing taxes, providing for multiple skips and valuing distributions. Careful GSTT planning can extend the benefit of an estate down through time to multiple generations in a tax efficient, if not tax free, manner.

A Word about Spouses

Each person has a unified credit. This means that each spouse has a unified credit, which means that a married couple may exempt a marital estate worth up to $10.68 million from transfer taxes. In the past, a certain amount of pre-death planning was required to make sure that each spouse's unified credit could be used. Starting in 2011, with apparently permanent enactment in 2013, it became possible through something called the **portability rule** to protect the use of each spouse's unified credit without the need for advance planning. The portability rule provides that at the time of the first spouse's death an election can be made to transfer that deceased spouse's unused unified credit to the surviving spouse. This election is made through the filing of the federal estate tax 706 return.

The portability rule, together with other spousal transfer tax planning tools, is discussed in a separate article, entitled *Spousal Unified Credit Planning & The Portability Rule*.

Conclusion

Transfer taxes play a significant role in the planning of many estates. In some estates, it is the first order of business: the first stage of planning. However, for most people, a unified credit amount equal to $5.43 million means that no transfer tax will be paid. One of the first questions to be asked and answered in estate planning is: what is the value of your estate? Answering this question usually means putting together an inventory of property, understanding how the property is titled, and estimating its value net of liabilities. This question is asked first in order to determine whether or not a transfer tax issue exists. If the unified credit exemption amount is sufficiently large to protect the estate from transfer tax, there may be no need to undertake any transfer tax planning. However, if the estate is so large that there may not be enough unified credit to protect the estate from transfer taxes, it is likely that the owner(s) of that estate will want to consider additional transfer tax planning. In other words, as far as transfer taxes are concerned, if you are a single person with an estate equal in value to $5.43 million or less, or if you are a married couple with an estate equal to $10.86 million or less, <u>so long as the law remains as enacted in the 2012 Tax Payer Relief Act</u>, breathe easy. Otherwise, seek counsel.

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