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**Transfer Taxation Part 2: Unique**

**Elements of Estate and Gift Taxes**

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## Introduction

This course is part of a three-part series on federal taxation for Estate Planning. The first course examined the history of federal transfer taxes and the fundamental elements that are shared by both gift and estate taxes. This course builds upon the first by examining first what is unique about the taxation of gifts and then examining what is unique about the taxation of estates. The third course, which concludes this series, will examine Generation-Skipping Transfer taxes and specific elements of income taxes that are relevant to estate planning. The material in this course, along with the other two in the series, should be considered as prerequisite to any study of estate planning techniques.

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| Objective  At the conclusion of this course, you will be able to:   * Identify what constitutes a gift. * Explain the annual gift tax exclusion and other gift tax exclusions for special purpose gifts. * Distinguish between the probate estate and the taxable estate. * Identify assets that encompass the probate estate. * Understand how the gift and estate tax are calculated and how to estimate the potential transfer tax exposure. * Recognize the tax-exclusive nature of gift taxes vs. the tax-inclusive nature of estate taxes. |

## The Federal Gift Tax

The federal gift tax applies to gifts of property made during the transferor’s lifetime. For U.S. citizens and resident aliens, the tax applies to all gifts of property, wherever situated. For nonresident aliens, the tax applies only to gifts of ***tangible******property*** situated in the United States.

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| **Tangible Property**  ***Tangible Property*** is property that can be felt or touched; having physical form. ***Real Property*** [land and whatever is erected upon it (*e.g.,* a house), growing on it (*e.g.,* crops), or affixed to it (*e.g.,* a fence)], is by its very nature tangible. Tangible ***Personal Property*** would include items like jewelry, furniture, automobiles, artwork, etc.  In contrast, ***Intangible Property*** is property that has no intrinsic and marketable value. Rather, it represents or gives evidence of value, such as stocks, bonds, patents, life insurance, etc. |

## Gifts

Not all lifetime transfers of property qualify as gifts for gift tax purposes. Generally speaking, a lifetime transfer is considered a gift if four conditions are met: **Move the mouse pointer to each item to learn more.**

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| **1. Both parties are competent adults**  Just as minors need a guardian or other entity such as a trust to hold property on their behalf, so do adults who are incompetent. |

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| **2. It is not an equal value exchange**  As the IRS Code states, the transfer must be "for less than an adequate and full consideration in money or money's worth." If payment for the full value of the transfer is received, it is not a gift. If partial payment is received with no requirement for further payment, then it is a partial gift of the balance. For example, selling your $500,000 house to your child for $300,000 is a gift of $200,000. |

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| **3. It is a completed transfer**  This means that actual receipt of the asset was taken or title to the property was changed. It also means that no strings are attached whereby the donor retains control or use of the asset. In the latter case, such gifts are considered incomplete.  For example, the donor who sells her house to her child for less than adequate consideration and **continues to live there rent-free** has not made a completed gift. |

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| **4. The transfer is irrevocable**  The term “irrevocable” means that once it is done, it cannot be changed; in other words, once the gift is made, the donor cannot change his or her mind and take it back. |

Given these conditions, many things can qualify as a gift:

* Gifts of cash
* Gifts of investment securities, such as stocks or bonds
* Forgiveness of a loan
* Purchasing an automobile or computer as a graduation present
* Creation of certain types of trust for the benefit of someone else

But sometimes it is not completely clear if a gift has been made, or when it is complete. For example, setting up a joint checking account with someone else. Does that constitute a gift? What if the other person withdraws the money? Another example might be a transfer of real estate where the donor retains the right to use the real estate during the donor's lifetime. Is that a completed gift, in whole or in part?

A full analysis of such situations is beyond the scope of this training module. Simply remember that **any transfer where the donor retains some control or current interest in the asset may not qualify as a gift** and would remain in the taxable estate of the donor. For such situations, a specialist should be involved.

## Gift Tax Deductions/Exclusions

Fortunately, not every gift to an individual is taxable. We have discussed elsewhere two deductions that apply to both lifetime gifts and estates at death:

* **Charitable Deductions** – Transfers to qualified charities, during one’s lifetime or at death, receive an offsetting deduction, which removes them from computation of gift and estate taxes.
* **The Unlimited Marital Deduction** – An unlimited amount can be transferred between U.S. citizen spouses, during life or at death, fully protected from transfer taxes. However, there is no unlimited marital deduction available for a transfer to a Spouse who is not a U.S. citizen.

In addition to these, there are four exclusions that are specific to lifetime gifts:

* **The Annual Gift Tax Exclusion** – This allows for annual gifts up to a specified amount to as many individuals as desired.
* **Direct Payment of Tuition** – As long as specific rules are followed, tuition payments on behalf of someone else are not taxable gifts.
* **Direct Payment of Medical Care** – Similarly, by following specific rules, payment care payments on behalf of someone else are not taxable gifts.

No lifetime gifts that qualify for one of these three exclusions or for the charitable or marital deduction are considered taxable gifts. Since these five gifts are *not* considered taxable gifts, we do not even have to use any of our Applicable Credit/Exclusion Amount to protect them from taxation.

On the following pages, we explore these four gift tax exclusions more thoroughly.

## Annual Gift Tax Exclusion

For 2016, lifetime gifts of a present interest in the amount of **$14,000 or less** can be made **annually to any individual,** and are **excluded** from the gift tax. Note that the gift tax exclusion is not limited to gifts to family members; it applies to gifts to ANY INDIVIDUAL.

For a gift to qualify for the annual gift tax exclusion, the IRS requires that the gift must be of a “***present interest.***” In other words, the person receiving the gift must enjoy an immediate benefit and the unrestricted right to use, possess and enjoy the property. No annual exclusion will be granted for a “***future interest***” where the right to use and enjoy the property does not take place until some future time. Nor will it be granted for an interest that is “***contingent***” upon the occurrence of an event or subject to the discretion of another person. There are, however, some exceptions that make it possible to make annual exclusion gifts to minors, even though someone else will manage and apply the funds for the benefit of the minor until the minor reaches adulthood.

This provides a significant ability for individuals with taxable estates to effectively transfer assets out of their estates without incurring a transfer tax. What is especially important to remember is that since annual exclusion gifts are not “taxable gifts,” they do not get added back to the estate upon the death of the donor. The gifted assets and all future appreciation on the assets are forever out of the donor’s estate. Given sufficient donees and sufficient years to make transfers, sizeable amounts can effectively avoid taxation.

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| **Donees**  Person or institution to whom a gift is made. |

Other factors to keep in mind: **Click each item to learn more.**

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| **There is No Limit to the Number of Gifts in a Year**  An individual can make $14,000 annual exclusion gifts to as many people as desired. |

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| **Gifts can be Made to Anyone**  The gift tax exclusion is not limited to gifts to family members. It applies to gifts to ANY INDIVIDUAL. |

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| **It is Not Cumulative**  In other words, it is either used or lost. If a year is skipped, the individual is not allowed to carry it forward into a subsequent year. |

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| **Indexed for Inflation**  Beginning in 1999, the exclusion was set at $10,000 and indexed for inflation using 1997 as the base year. The indexing is rounded down to the next lowest multiple of $1,000, meaning it may be a number of years between changes. For 2012, it was $13,000; it increased to $14,000 in 2013 and has remained at $14,000 through 2016. |

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| **Gift-Splitting**  Spouses who are U.S. citizens or resident aliens can “elect to” or “consent to” split gifts between them for a combined $28,000 (in 2016) to any individual, and the entire amount qualifies for the annual gift tax exclusion. This is true even if the source of the funds is entirely from one spouse. A gift tax return *must* be filed when electing to split a gift.  *Note*: a spouse who is a non-resident alien cannot make a gift-splitting election. |

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| **No Gift Tax Return Required (unless splitting gifts)**  There is a de minimus rule in regard to record keeping. For gifts of $14,000 or less (in 2016), no gift tax return need be filed, provided gift-splitting is not involved. Just keep personal records; no reporting is necessary. |

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| **Gifts to a Non-Citizen Spouse**  Normally, gifts between spouses qualify for the unlimited marital deduction and are nontaxable events for gift tax purposes; but the unlimited marital deduction does not apply for a gift to a spouse who is not a U.S. citizen.  To mitigate this, an expanded Annual Exclusion Amount of $148,000 (in 2016, as indexed) is allowed for gifts to a non-citizen spouse. This amount is indexed for inflation. |

## Other Gift Tax Exclusions

In addition to the Annual Gift Tax Exclusion, there are two other important lifetime transfers that are not subject to gift taxation.

For the basic characteristics of each, **click each item below:**

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| **Direct Payment of Tuition**   * It is limited to tuition (books, dormitory, student fees, etc. do not qualify). * Payment must be made directly to the school (it cannot be given to the student with the intent that the student pay the tuition). * There is no limit on the amount. * This is in addition to the annual gift tax exclusion. * Payment can be for anyone. * As a “non-taxable” gift, it is not added back to the donor’s estate at death. |

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| **Direct Payment of Medical Care**   * The IRS defines specific expenses that qualify, but in general, they cover the expenses of diagnosis and treatment. * It is not allowed for amounts reimbursed by insurance. * Payments must be made directly to the doctor or health care facility providing the care. * There is no limit on the amount. * This is in addition to the annual gift tax exclusion. * Payment can be for anyone. * As a “non-taxable” gift, it is not added back to the donor’s estate at death. |

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| **Example**  Suppose that in 2016 a grandparent wishes to pay his grandchild’s tuition bill of $20,000 (this can be for college or pre-college tuition). The grandparent can pay his grandchild’s tuition bill directly to the educational institution and it will NOT be considered a reportable gift. If, however, the grandparent gives the grandchild the $20,000 so that the grandchild can pay the tuition, then the grandparent has made a taxable gift of $6,000 ($20,000 minus the $14,000 annual exclusion gift) and must file a gift tax return.  The same is true for medical expenses paid directly to the medical provider. If paid directly to the service provider, no taxable gift has been made and therefore none is reported. |

## Calculating the Gift Tax

Now that we have covered the basic features of the gift tax, just how is the tax computed? The basic structure of the gift tax calculation is outlined below. Unless you plan to file complete gift tax returns, it is not important that you memorize every step in the process. But it is important that you note the comments on the highlighted steps. **Click each of the highlighted steps.**

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| Total gifts during the year  Less:  Annual exclusion (per done)  Charitable deduction  Marital deduction  Taxable gifts for the year  Plus:  Taxable gifts for all prior years  Total of current and past taxable gifts | $\_\_\_\_\_\_\_\_\_\_\_\_\_    (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  $\_\_\_\_\_\_\_\_\_\_\_\_\_  +\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  $\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| Compute tentative gift tax on the preceding total  Less:  Prior gift taxes paid  Applicable Credit Amount applied  Gift tax due | $\_\_\_\_\_\_\_\_\_\_\_\_\_    (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  $\_\_\_\_\_\_\_\_\_\_\_\_\_ |

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| **Total gifts during the year**  Gifts are valued on the date the property is transferred from the control of the donor. |

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| **Taxable gifts for the year**  If the annual exclusions, charitable deduction, and marital deduction cover all the gifts made during the year, then this will be zero and it is not necessary to file a tax gift tax return. |

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| **Taxable gifts for all prior years**  Just as lifetime gifts are added back before calculating the tentative tax on an estate, so are prior taxable gifts added back when computing the gift tax. |

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| **Compute tentative gift tax on the preceding total**  Just like the estate tax return, the tentative tax is computed before the Applicable Credit Amount is applied. |

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| **Gift tax due**  The liability for paying the gift tax rests with the donor. Gift taxes are to be paid on an annual basis, and are typically filed by April 15 of the following year, along with the 1040. |

## Review Exercise

Let'sreview some of the concepts we have covered so far. Answer the following questions as true or false:

1. **In 2016, a husband and wife can make a joint gift of $28,000 that qualifies for the annual gift tax exclusion only if each of them contributes half from their separate funds:**

* True

**Incorrect**. It is not necessary for a husband and wife to use separate funds when splitting a gift.

* **False**

**Correct**. It is not necessary for a husband and wife to use separate funds when splitting a gift.

1. **There is no limit on the number of $14,000 gifts that can be made in 2016 under the annual gift tax exclusion, as long as each gift is to a different person:**

* **True**

**Correct**. There is no limit to the number of persons as long as no individual receives over $14,000.

* False

**Incorrect**. There is no limit to the number of persons as long as no individual receives over $14,000.

1. **If a single parent skips 2 years in making gifts to a daughter, in the third year the parent can qualify $42,000 (assuming $14,000 is the limit in all 3 years) for the annual gift tax exclusion:**

* True

**Incorrect**. The power to make a gift that qualifies for the annual gift tax exclusion lapses each year if not used. In other words, the annual gift tax exclusion is not cumulative.

* **False**

**Correct**. The power to make a gift that qualifies for the annual gift tax exclusion lapses each year if not used. In other words, the annual gift tax exclusion is not cumulative.

1. **If a married couple wishes to directly pay their son's $28,000 annual college tuition in 2016, any additional gifts to their son in 2016 would be taxable:**

* True

**Incorrect**. The exclusion for tuition is in addition to the annual gift tax exclusion.

* False

**Correct**. The exclusion for tuition is in addition to the annual gift tax exclusion.

1. **Mr. Jones gives his mother $25,000 for her to pay her medical care expenses. Because it is for medical care, the gift to his mother is excluded from gift taxes:**

* True

**Incorrect**. Mr. Jones must make direct payment for medical care for it to qualify for the health care exclusion; he cannot give it to his mother for her to make the payment.

* **False**

**Correct**. Mr. Jones must make direct payment for medical care for it to qualify for the health care exclusion; he cannot give it to his mother for her to make the payment.

## Estates

We now turn our attention from gifts to the settlement of estates when people die. To understand characteristics unique to estates, it is important to understand what is included in the gross estate and how it is calculated. In calculating the gross estate, don't confuse the taxable estate with the probate estate. The probate process involves the court supervision of the administration of the will, payment of creditors, changing titles to property, and the distribution to heirs. The estate tax process includes all the assets that are probated, but there are other assets that are owned by the deceased that do not go through probate, yet are included in the estate tax return. Primary examples are life insurance, retirement accounts, jointly owned property, and various trusts.

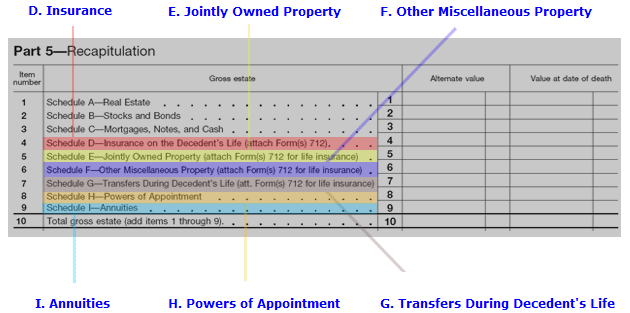
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| **Probate estate**  Portion of the estate that goes through the probate process. |

The first step in computing the estate tax is to identify all assets that are included in the **gross estate** (before adjustments) and record them on Form 706 (the form used for the Estate Tax Return). Essentially, everything owned by the deceased person is included in the gross estate.

Most of the time, it is easy to identify what is owned by the deceased: cash, stocks, bonds, automobile, real estate in the deceased name, and personal property like clothes and furniture. But some items are not as readily apparent. To get a better understanding of other assets that will be included, the next page depicts the section in Form 706 that totals the gross estate. Be sure to move the mouse pointer to each of the highlighted items on the form, which will provide commentary regarding details with which you should be aware.

## Totaling the Gross Estate

Here is the section of Form 706 where the gross estate is calculated. Some of the items are self-explanatory; others are not. To establish a foundation for understanding the estate planning process, it is important that you have some understanding of each of these items. **Click each of the highlighted sections for more information on those items that are not readily apparent:**



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| **D. Insurance**  It is common sense that if insurance proceeds on the life of the deceased (who is legally referred to as the “decedent”) are payable to the estate, then the proceeds are included in the gross estate. But it would surprise many people to know that even where insurance proceeds are paid out to beneficiaries and the estate receives nothing, the estate must report the full amount of the insurance on the estate tax return if the deceased owned the policy. This is why many people have taxable estates that are beyond the Applicable Exclusion Amount, even though they don’t realize it.  The IRS says any of the following incidents of ownership will qualify the deceased as owning the policy and include it in the deceased’s estate, even if the deceased could not act independently but had to act in conjunction with another person. The incidents of ownership in a policy as outlined by the IRS include:   * The right of the insured or estate to its economic benefits * The power to change beneficiaries * The power to surrender or cancel the policy * The power to assign a policy or to revoke an assignment * The power to pledge the policy for a loan * The power to obtain from the insurer a loan against the cash value of the policy.   In short, if the deceased had any power whatsoever over the policy, the amount of the proceeds is included in the deceased’s estate.  To avoid the inclusion of life insurance in a person’s estate, a common planning technique is to establish an irrevocable trust, which will either purchase a new policy or to which an existing policy will be transferred. The trust, commonly known as an Irrevocable Life Insurance Trust, will be both the owner and beneficiary of the policy, thereby keeping ownership out of the person’s estate. However, as discussed under Schedule G, please note that transfers of insurance within three years of death must be added back to the estate. Therefore, if an existing policy is transferred to an irrevocable trust, rather than the trust purchasing a new policy, the transferring owner must live for three years beyond the transfer for the policy to be excluded from his or her estate. |

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| **E. Jointly-Owned Property**  A more thorough discussion of jointly owned property is contained in a separate module. For our purposes here, simply know that jointly owned property is included in the estate to the extent of the deceased’s interest in the property. |

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| **F. Other Miscellaneous Property**  This is a catchall for items not listed elsewhere. It would include such things as the deceased’s automobile, household goods and personal effects, jewelry, and art collections. It might also include such items as interests in a business, royalties, and livestock. |

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| **G. Transfers During Decedent's Life**  The term “decedent” is the legal term for the deceased.  For certain transfers, if the decedent made the transfer within 3 years of death, then the assets are still included in the decedent’s estate. This applies to Life Insurance. Thus, to successfully transfer life insurance out of your estate, you must transfer it to another individual or irrevocable trust, and then live for three more years.  Furthermore, if the decedent had incomplete transfers of property, where he/she retained certain rights over the property, then the property is generally included in the decedent’s estate. Examples of incomplete transfers would include retained powers to:   * Determine solely or with another person who had right to use of the property * Determine solely or with another person who had right to income from the property * Use the property or collect income for oneself * Vote the shares |

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| **H. Powers of Appointment**  If the decedent (deceased) had a general power of appointment over property that he/she did not own, that property is included in his/her estate. This is usually associated with a trust that was established by someone other than the decedent. Having a general power over the assets means that the deceased had the power to appoint the assets to himself, his estate, or his creditors. In other words, the general power gave him the power to use the assets as he wished, even though they were not titled in his name. |

## Valuation

In determining the value of property that is included in the estate tax return, valuation can either be at the time of death or an election can be made to use the **alternate valuation date**, which is **6 months after death**. But the alternate valuation date can only be used if it results in lower taxes. Any assets that are distributed or sold prior to the alternate valuation date will use the value at which they were distributed or sold.

All valuations must be at fair market value. Determining a fair market value is not always simple. While beyond the scope of this course, be aware that there are many rules regarding how to determine the value of various assets.



## Special Circumstances

Some estates may claim special estate tax benefits that result in lower taxes or allow payment of the taxes in installments. If there is a subsequent change in the circumstances that led to those tax benefits, the tax savings may be recaptured by the government or the tax installments may be accelerated. Two such situations are illustrated below. **Click on each for an illustration.**

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| **Special Use Valuation**  Under certain circumstances, property may qualify for a "special-use valuation," under Section 2032A of the tax code, which substantially reduces its value for estate tax purposes. For example, a farm might be located in an area that is rapidly undergoing residential development, with significantly higher property value. The farm may be worth much less as a farm than it would be if put on the market for residential development. For estate tax purposes, the value of the land might be adjusted downward from its market value due to its special use, with the maximum adjustment for real property being $1,110,000 in 2016 (adjusted for inflation from $750,000 in 1997). Current rules state that if the heirs cease to use the property in its qualified use within 10 years of the decedent's death, then the estate tax savings from special use must be recaptured. |

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| **Installment Payments of Estate Taxes for Estates with an Interest in a Closely-Held Business**  Estates with an interest in a closely-held business, the value of which exceeds 35% of the adjusted gross estate, may qualify for payment of the estate tax in installments. But if more than 50% of the value of the closely-held business is disposed of before completion of those installment payments, the unpaid portion of the tax payable in installments must be paid upon notice and demand of the Treasury Secretary. |

## Calculating the Estate Tax

Having examined in some detail what is included in the gross estate, let's examine how the tax is computed. The basic structure of the estate tax is outlined below. Unless you plan to file complete estate tax returns, it is not important that you memorize every step in the process. But it is important that you note the comments on the highlighted steps. **Click on each of the highlighted steps.**

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| Gross estate  Less deductions:  Charitable deduction  [Marital deduction](javascript:void(0))  [Deductible estate expenses](javascript:void(0))  State Death Tax Deduction  Taxable estate  Plus post-1976 taxable gifts  Total on which estate tax is computed | $\_\_\_\_\_\_\_\_\_\_\_\_\_  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  $\_\_\_\_\_\_\_\_\_\_\_\_\_  +\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  $\_\_\_\_\_\_\_\_\_\_\_\_\_ |

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| **Marital deduction**  If the surviving spouse is a U.S. citizen, then all property transferred to the surviving spouse qualifies for the marital deduction. This transfer can be outright or to a marital trust that will be included in the surviving spouse's estate. Remember that to qualify for the marital deduction, the assets must be includable in the surviving spouse's estate when transferred.  If the surviving spouse is not a U.S. citizen, then assets will have to be placed in a qualified domestic trust (QDOT Trust) to qualify for the marital deduction. |

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| **Deductible estate expenses**  This includes attorney fees, executor expenses (which can be paid to family members), funeral expenses, creditor claims, income taxes, property taxes, etc. |

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| [Compute tentative tax on the above total](javascript:void(0))  Less Prior Gift Taxes Paid (on post-1976 gifts)  Gross Estate Tax  Less Credits:  [Applicable Credit Amount](javascript:void(0))  Credit for tax on pre-1977 gifts  [Estate tax due](javascript:void(0)) | $\_\_\_\_\_\_\_\_\_\_\_\_\_  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  $\_\_\_\_\_\_\_\_\_\_\_\_\_    (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  (\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_)  $\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| **Compute tentative tax on the above total**  Note that the tax is computed *before* any distributions are made, while the gift is computed *after* the distribution is made. Why this is significant will be explained later. | | | |

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| **Applicable Credit Amount**  Only the Applicable Credit Amount, not the Applicable Exclusion Amount, is used in calculating the tax. |

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| **Estate tax due**  Unless deferred, the estate tax is due 9 months after death. The party who is appointed to settle the estate is primarily responsible for paying the estate tax. As we have seen, this responsibility can include payment of the tax liability for assets that were outside of probate, such as insurance proceeds that were paid directly to survivors.  If no one is appointed by the court to settle the estate, then the person in possession of the deceased person's property becomes responsible. This is why trustees often become responsible for the estate tax. Where all assets were transferred to trust prior to death and there is no probate estate, it is the trustee who possesses the funds with which the estate tax must be paid, and therefore it becomes the trustee's responsibility. This is one reason why the trustee cannot always immediately distribute funds to beneficiaries after the death of the person who created the trust. |

## Portability of the Applicable Exclusion Amount

Beginning in 2011, a new concept was introduced to the federal gift and estate tax laws known as the “***portability***” of the Applicable Exclusion Amount. By “portability,” we mean that it is now possible for the unused portion of a deceased spouse’s Applicable Exclusion Amount to be transferred (or transported over) at death to the surviving spouse. This does not apply, however, for deaths of spouses that occurred prior to 2011.

Stated differently, when one spouse dies, the surviving spouse has their own “Basic” Exclusion Amount PLUS the ***“Deceased Spousal Unused Exclusion (DSUE) Amount.”***  If someone is predeceased by more than one spouse, then it is the ***last deceased spouse*** for whom this portability applies.

This change significantly impacts estate planning and makes it possible for a surviving spouse to have a significantly enhanced Applicable Credit/Exclusion Amount for use on the estate tax return. To make use of it, the executor simply files an estate tax return and chooses to not opt out of portability on the return. Furthermore, portability is available for both U.S. citizen and resident alien spouses; it is not available to nonresident aliens.

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| **Overview** | While this sounds simple, it can actually get a bit complicated. Fortunately, this added complexity makes for some planning risks and opportunities. The best way to illustrate this is with several similar examples, going from the simple to the more complex. Study these examples carefully, as they illustrate some important planning considerations regarding portability.  **Click each example to learn more.** |
| **Example 1** | Mr. Andrews died in 2012 when his Applicable Exclusion Amount was $5,120,000. He never made any lifetime taxable gifts and passed his entire estate on to his wife, using the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to her.  Mrs. Andrews died in 2016. She, too, had never made any lifetime taxable gifts, so the Applicable Exclusion Amount available to her estate equaled her own 2016 Basic Exclusion Amount of $5,450,000 plus the $5,120,000 DSUE Amount she received from her deceased husband, for a combined total of $10,570,000. ***Please note that her Basic Exclusion Amount (i.e., her own Applicable Exclusion Amount) was increased by inflation from 2012 to 2015, while the DSUE Amount she received from her deceased husband remained fixed by the year of his death.*** |
| **Example 2** | Jane’s first husband died in 2012 when his Applicable Exclusion Amount was $5,120,000. He had never made any lifetime taxable gifts and passed his entire estate on to Jane, utilizing the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to Jane.  Jane remarried in 2014 and her second husband died in 2015. Jane’s second husband had a will that left his entire estate of $10,000,000 to his children from a prior marriage, totally using up his entire Applicable Credit/Exclusion Amount and transferring no DSUE to Jane.  Jane died in 2016. According to the rules of portability, her estate can no longer use the $5,120,000 DSUE she received from her first husband’s estate because the rules dictate that her estate can only use the DSUE from her ***last deceased spouse***. Unfortunately, her last deceased spouse’s estate left her with no DSUE. Thus, her estate is left solely with her own Basic Applicable Exclusion Amount of $5,450,000.  ***This example highlights a risk associated with DSUE and remarriage. In the next example, we will see a planning technique that can potentially address that risk.*** |
| **Example 3** | Sarah’s first husband died in 2012 when his Applicable Exclusion Amount was $5,120,000. He had never made any lifetime taxable gifts and passed his entire estate on to Jane, utilizing the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to Sarah.  Sarah remarried in 2014. Immediately upon remarriage, she made taxable gifts in the amount of $5,120,000 to her children from her prior marriage. The rules dictate that when a surviving spouse with DSUE makes lifetime taxable gifts, the DSUE is used up before the surviving spouse’s own Basic Credit. Thus, in making the gifts to the children, Sarah totally used up the DSUE from her first husband.  Sarah’s second husband died in 2015 when his Applicable Exclusion Amount was $5,430,000. He had never made any lifetime taxable gifts and passed his entire estate on to Sarah. His estate used none of his Applicable Exclusion Amount and, ***since he was now her last deceased spouse***, his estate transferred $5,430,000 of DSUE to Sarah.  Sarah died in 2016. Her Applicable Exclusion Amount equals her own Basic Exclusion Amount of $5,450,000 plus the $5,430,000 DSUE Amount she received from her second deceased husband (now the last deceased husband), for a combined total of $10,880,000.  This example highlights a planning opportunity associated with DSUE and remarriage. Realizing the risk that she could lose the DSUE from her first deceased husband if her second husband predeceased her, Sarah quickly used up the DSUE from her first deceased husband. The end result was that ***Sarah got to make use of the DSUE from both of her deceased husbands and had sufficient transfer tax credits to protect a total of $16,000,000 from taxation.*** |

## State Transfer Taxes

Depending upon the state in which you reside, state transfer taxes may also impact the tax cost of transfers. Only a handful of states have a gift tax, but one or more of the following may be found in any given state. Therefore, it is important to discern the practices in a client’s state and any additional state taxes should be taken into consideration. **Click each type of death tax to learn more.**

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| **Pickup Tax**  When Congress permanently instituted an estate tax in 1916, states were upset because this infringed upon their traditional tax base. In response, Congress instituted a credit against the federal tax for death taxes paid to states. Since the state “**pick up**” tax equaled the credit allowed, there was no impact on the total tax bill paid by the decedent. The only result was that part of the tax revenue was shared with the state in which the decedent was domiciled.  The Tax Relief Act of 2001 began phasing away this credit. Beginning in 2002, this credit was reduced by 25% per year and it disappeared totally for deaths occurring in 2005.  A deduction on the federal estate tax return for state-imposed estate or inheritance taxes replaced the credit on the federal estate tax return for 2005 and after. Since the change in the federal law, a number of states have enacted their own estate tax laws to replace the pickup tax. |

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| **Estate Tax**  The **estate tax** functions similar to the federal estate tax, and is assessed on the value of the estate. |

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| **Inheritance Tax**  An **inheritance tax** is the oldest form of death tax, although most states no longer levy it. It is typically levied at a graduated rate based on the amount of the bequest and the relationship to the deceased of the person receiving the bequest. In all states, bequests to spouses are exempt from the inheritance tax. Some states even exempt children and close relatives. In general, the closer the relationship was with the deceased, the less the tax. |

## Review Exercise

1. **Upon Mrs. Goldsmith’s death, indicate which of the following items would be included in Mrs. Goldsmith's estate tax return by choosing the appropriate yes or no response below:**

**Her bank certificate of deposit that will automatically distribute to her son upon her death.**

* **Yes**

**Correct**. Since she could change this designation while alive, she had full control of those funds.

* No

**Incorrect**. Since she could change this designation while alive, she had full control of those funds.

**Mrs. Goldsmith's life insurance policy in which she named her son as the beneficiary.**

* **Yes**

**Correct**. She owned the policy and had the power to name the beneficiary, therefore it is included in her estate even though the proceeds are payable to her son.

* No

**Incorrect**. She owned the policy and had the power to name the beneficiary, therefore it is included in her estate even though the proceeds are payable to her son.

**Insurance on her life that was purchased by her son naming himself as the beneficiary.**

* Yes

**Incorrect**. She was not the owner of the policy, therefore the proceeds are not part of her estate.

* **No**

**Correct**. She was not the owner of the policy, therefore the proceeds are not part of her estate.

**Mrs. Goldsmith's life insurance policy that she transferred to an irrevocable trust five years ago**

* Yes

**Incorrect**. The policy would be included in her estate only if she made the transfer less than three years ago.

* **No**

**Correct**. The policy would be included in her estate only if she made the transfer less than three years ago.

**Her personal property**

* **Yes**

**Correct**. Her personal property is part of her estate.

* No

**Incorrect**. Her personal property is part of her estate.

**Her funeral expenses**

* Yes

**Incorrect**. While funeral expenses can be deducted from the estate, they are not themselves part of the estate upon which taxes are calculated.

* **No**

**Correct**. While funeral expenses can be deducted from the estate, they are not themselves part of the estate upon which taxes are calculated.

**The rental property she transferred to her son, where she retained the right to the rental income**

* **Yes**

**Correct**. This is an incomplete transfer and it is brought back into her estate.

* No

**Incorrect**. This is an incomplete transfer and it is brought back into her estate.

**Her annuity that she purchased two years ago that pays out to her son upon her death**

* **Yes**

**Correct**, since she purchased the annuity.

* No

**Incorrect**, since she purchased the annuity.

**The annuity that her son purchased to provide her with income and which pays a death benefit to her son upon her death**

* Yes

**Incorrect**, because the annuity was purchased by her son.

* **No**

**Correct**, because her son purchased the annuity.

1. **Assuming no extensions, the estate tax return Form 706 is due how many months after death?**

* 3 months

**Incorrect**. Try again.

* 6 months

**Incorrect**. Try again.

* **9 months**

**Correct**.

* 12 months

**Incorrect**. Try again.

1. **If an asset in an estate receives a special use valuation, thereby reducing the estate tax on the asset, the tax benefit must be recaptured if the heirs cease to use the property in its "qualified use" within how many years of the decedent’s death?**

* 3 years

**Incorrect**. Try again.

* 5years

**Incorrect**. Try again.

* **10 years**

**Correct**.

* 15 years

**Incorrect**. Try again.

1. **The alternate valuation date is:**

* 3 months after the date of death

**Incorrect**. Try again.

* **6 months after the date of death**

**Correct**!

* 9 months after the date of death

**Incorrect**. Try again.

* 12 months after the date of death

**Incorrect**. Try again.

1. **With portability, a surviving spouse’s Applicable Exclusion Amount equals their Basic Exclusion Amount plus the:**

* **DSUE**

**Correct.** They get to add the Deceased Spousal Unused Exclusion Amount.

* DSSU

**Incorrect.** Try again.

* DESU

**Incorrect.** Try again.

* DUSE

**Incorrect.** Try again.

## Gifts are Tax Exclusive / Estates are Tax Inclusive

Having looked at both the gift tax calculation and the estate tax calculation, there is one final point to be made on how their calculations differ. It is best understood by looking at an example, such as the one below:

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| **EXAMPLE**  For the sake of illustration, let’s assume it is 2016 and Mr. Johnson has already made sizeable lifetime taxable gifts of $5,430,000 and has completely used up his Applicable Credit Amount. He has also already made annual exclusion gifts to his relatives (including his nephew) in 2015, so any further lifetime gifts to them will be taxable gifts, which will be taxed at 40%.  Let’s further assume he is seriously ill and expects to die before year-end. In his will, he plans to leave $100,000 to his nephew. His question is this: “Is there any advantage to gifting the $100,000 to my nephew now, rather than waiting until I die?”  At first glance, it would appear to make no difference. If he makes the gift while alive, he will pay at the tax rate of 40%. If he waits for his estate to make the transfer upon his death, it too will pay at the tax rate of 40%. Since both transfers get taxed at the same rate, aren’t the results the same? To see, let’s walk through both scenarios and make the calculations.  **Distribution during lifetime.** Since the gift tax must be paid by the donor, Mr. Johnson gives his nephew $100,000 and allocates $40,000 to pay the gift tax. Total cost of the transfer = $140,000.  **Distribution at death.** What would happen with that same $140,000 if he retained it in his estate? Well, the $140,000 would be subject to estate taxes at 40%. This gives a tax of $56,000 and leaves a balance of $84,000 vs. $100,000 for his nephew. The IRS got more in taxes, requiring additional funds to be allocated if the nephew is to receive the full $100,000. How come? |

The reason that the lifetime gift was more tax-efficient than the estate transfer is explained by the following:

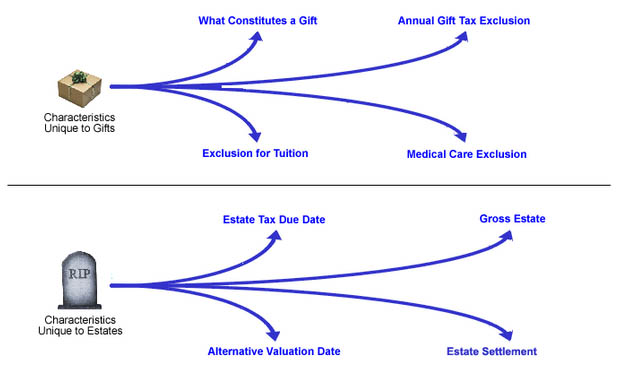
|  |
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| ***Gifts are “tax exclusive,”*** meaning the funds used to pay the gift tax are excluded from the tax base. In our example of the lifetime gift, we computed the tax on the $100,000 gift, not on the entire $140,000, so the money used to pay the tax was not part of the base upon which we computed the tax bill. In fact, no tax was ever computed on the $40,000 that went to the IRS, so it got excluded from transfer taxation.  ***Estates are “tax inclusive,”*** meaning the funds used to pay the estate tax are included in the tax basis. In our example of the distribution at death, we computed the estate tax on the entire $140,000, so the money used to pay the estate tax was part of the base upon which we computed the tax bill. Thus, in estates, everything gets included in transfer taxation; even the funds that are used to pay the tax get included in being taxed. |

If you find this is somewhat like understanding Einstein's theory of relativity, don't worry about it. The important thing to remember is that the taxation of lifetime gifts is more favorable than the taxation of estates because of the manner in which the calculation is done. If given a choice between making a taxable transfer as a lifetime gift or through the estate, it is more tax efficient to make the lifetime gift.

However, there is one caveat. To prevent people from making “death bed” transfers, thereby achieving a lower gift tax than would be achieved by the estate tax upon death, the IRS requires that gift taxes paid within three years of death must be added back to the estate and thereby becomes part of the tax base. In this way, the money used to pay the gift tax is now included in a “tax inclusive” manner with the estate tax calculation, thereby negating the tax savings that was achieved by the lifetime transfer within three years of death. So, in our illustration of Mr. Johnson, it ends up there is no advantage in making the lifetime gift because he is not expected to live for three years after making the transfer.

## Unique Characteristics of Gift and Estate Taxes

This concludes the examination of the unique characteristics of gifts and estates. Below is a summary of the material that has been covered. Review this material carefully before proceeding to the next page. **Click each topic to make sure you have learned the content.**



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| **What Constitutes a Gift**   * Both parties are competent * Unequal exchange * Completed transfer * Irrevocable transfer |

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| **Annual Gift Tax Exclusion**   * $14,000 per year to ANY INDIVIDUAL in 2016 * Indexed for inflation in $1,000 increments * Husband and wife can split gifts regardless of source of funds * Not cumulative |

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| **Exclusion for Tuition**   * Direct payment for tuition only * For ANY individual and ANY NUMBER of individuals * No limit on amount * Does not affect the Annual Gift Tax Exclusion |

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| **Medical Care Exclusion**   * Direct payment of medical care expenses * For ANY individual and ANY NUMBER of individuals * No limit on amount * Not allowed for amounts reimbursed by insurance * Does not affect the annual gift tax exclusion amount |

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| **Estate Tax Due Date**   * 9 Months after death, unless deferred |

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| **Gross Estate**   * Includes everything owned by the decedent to the degree he/she had an interest in the property * Includes life insurance owned by the deceased * Includes life insurance transferred within 3 years of death * Incomplete transfers are added back. |

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| **Alternate Valuation Date**   * 6 months after date of death * Can only be elected if it reduces the tax |

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| **Estate Settlement**   * For deaths in 2016:   + Applicable Exclusion Amount is $5,450,000   + Portability makes it possible for the surviving spouse to use the DSUE amount of the last spouse who died after portability went into effect in 2011   + Maximum tax rate is 40% |

## Cumulative Review Exercise

Before continuing to the study of Generation Skipping Taxes, complete the following exercise on gift and estate taxes. **Match the following terms by entering the letter of the corresponding choice from the box below:**

|  |  |
| --- | --- |
| **A. Tax exclusive** | **F. 706** |
| **B. 9 months after death** | **G. $28,000** |
| **C. $14,000** | **H. 708** |
| **D. 6 months after death** | **I. Unlimited** |
| **E. Tax inclusive** |  |

**1.** **Gift taxes are:** **A**

**2. Estate taxes are: E**

**3. Alternate Valuation Date: D**

**4. Estate tax return form: F**

**5. Individual annual gift tax exclusion amount in 2016: C**

**6. Medical care exclusion amount: I**

**Correct.**

**Incorrect.** Try again.

## Summary

The following is a quick review of the key concepts contained in each section of this course:

|  |  |
| --- | --- |
| **Section:** | **Key Points** |
| Characteristics Unique to Estates | * What is included in the gross estate * Alternative valuation date * When the estate tax is due * General outline of how the estate tax is calculated * Estate taxes are tax inclusive * Portability (DSUE amount) beginning in 2011 * 2016 Applicable Exclusion Amount is $5,450,000 * Maximum tax rate in 2016 is 40% |
| Characteristics Unique to Gifts | * What constitutes a gift * Annual gift tax exclusion and gift splitting * Direct payment for tuition and medical expenses * General outline of how the gift tax is calculated * Gift taxes are tax exclusive |

## Conclusion

This concludes the material for this subject. At this time, you may return to any sections in which you feel the need for further study.