Chapter V

Tax Aspects of Estate Planning

A. Overview and Purpose

People decide to plan their estates for a wide range of reasons. These can include preserving a business, completing a management plan that will allow a property owner to fully realize the value of a particular asset, supporting a charity or other entity that serves the public interest, or simply saving money by reducing expenses, saving taxes, or providing for a more efficient means of transferring property after the owner’s death.

A common reason for deciding to embark on the planning process is to avoid estate and death expenses and taxes that arise when property is transferred after the property owner's death. Taxes are by no means the only issues that should be addressed in a thorough estate plan. Some of the tax issues are fairly common and well known, such as state and federal income taxes. Others, however, are less well known, such as federal estate and gift tax, state-imposed estate taxes, and federal generation skipping transfer tax. A reason these taxes are less well known is that they are limited in their application and therefore less frequently encountered in an average person's lifetime.

Recognizing that the transfer of property after a person's death is a trigger for imposing inheritance and estate taxes, many individuals plan during their lifetimes to avoid these taxes at their death. While planning can be an effective way to deal with these taxes, lifetime actions may trigger application of other tax laws (such as the federal gift tax) to lifetime transfers. Planning decisions must recognize the potential that these taxes will apply and then deal with them effectively in implementing decisions.

In this chapter we will discuss these taxes by emphasizing the nature of the tax, the tax rate, and the situations to which the taxes apply. In addition, we will focus our attention on opportunities under the various laws to make planning decisions that can minimize or even eliminate the tax when the property is transferred.

The Importance of Timing

In many parts of the discussion, the emphasis will be on the occurrence of planning or tax triggering events. Under current law, timing is an important consideration that will become clearer as the discussion unfolds. In a series of amendments made to the federal estate and gift tax law in 2001, changes were to be phased in before January 1, 2010. On January 1, 2010 the amendments provided that the entire Federal Estate Tax law is to be repealed. However, these amendments themselves are set to expire after December 31, 2010. When the amendments expire, the existing law will return and become effective. Since the amendments will expire after 2010, all changes in the old law that would have taken place, will be applicable in 2011 and later years. At present, many people believe that Congress will re-visit these tax laws and make other
adjustments to them and extend the period of the Federal Estate Tax repeal beyond December 31, 2010. Time will tell.

B. Lesson Objectives

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Describe the state and federal income tax issues and considerations that arise from a person's death and that apply to the person's personal income tax situation and that of his or her estate.
2. Describe and compare the provisions of a typical state inheritance tax and the Federal Estate Tax.
3. Describe and compare the typical state inheritance tax provisions relating to gifts of property to the provisions of the Federal Gift Tax.
4. Describe the estate planning opportunities provided by the unified credit against federal estate and gift taxes and the marital deduction.

C. Federal Income Tax

1. The Decedent's Final Returns

When a person dies, the first income tax issue that arises involves the decedent's tax return for all prior years for which a return was not filed, including a return for the year in which the decedent died.

Example: If an individual dies in January or February before filing his or her tax return for the prior year, the person may have two outstanding income tax years to report, -- the prior year's return which was not filed and the tax return for the year that begins on January 1 and ends on the date of the person's death.

In the case of the decedent's personal income tax return, the personal representative of the estate files the return on behalf of a decedent who is a single taxpayer at death. If the decedent was married in prior tax years and the decedent's spouse survives, the surviving spouse can file a joint return for the prior years and the year of death if the spouse has not remarried before the end of the tax year. If the spouse has remarried before the end of the tax year, the deceased spouse's filing status is that of married filing separately.

For the prior years and the year of the decedent's death, the tax rates that apply to reported income are the same rates that apply if the individual were still alive. Income earned during the tax years is treated in the same way as it was treated before death. The return for a prior year is filed by the deadline for filing that return, such as April 15 for an individual taxpayer who reports on a calendar year basis. The return for the year of the decedent's death must be filed by the date the decedent's return would have been due had death not occurred. In the example above where the decedent died in January or February, the decedent's return for the year of his death would be due by April 15 of the year following his or her death. In the return for the
decedent's final tax year, all income received during the year is reported as income for a cash basis taxpayer. All expenses actually paid are reported as deductible expenses. An exception to this rule applies to medical expenses paid by the decedent's estate after the decedent's death, but incurred before the decedent's death. If the decedent's estate does not deduct the expenses in calculating federal estate tax and the expenses are paid within one year of the decedent's death, the expenses can be deducted on the final income tax return. In addition, medical expenses paid for a deceased spouse or dependent are treated as medical expenses in the year in which the expenses are paid regardless of whether it is before or after the year of the decedent's death.

If income is reported on an accrual basis, the final return will report the income that the decedent accrued, or earned, before the decedent's death. Those items for which the decedent became liable before death are treated as deductible expenses under the accrual method.

If a decedent has a right to receive income during lifetime, but does not actually receive it or report it as income in the decedent’s final return, the income is known as income in respect of a decedent, or IRD when it is received. Such income is reported in the gross income of the decedent's estate in the year in which the estate actually receives it. A forest landowner growing crops or trees at the date of death does not normally give rise to IRD or income to be included in the final return. However, if the landowner receives rent in the form of a hunting lease and owns that lease at the time of death, the rental income is treated as IRD and is reported in the year in which the rent is received. If the landowner dies during the lease period, and the rent is paid after the owner’s death only the rent that relates to the portion of the rental period that ends with death is treated as IRD. The remaining portion of the rent is treated as income to the estate.

Example: Al Roberts is a forest landowner who leased hunting rights for a one-year period beginning March 1. The rental amount is $5 per acre or $2,000 for a 400 acre tract. On June 30, Roberts died. Roberts was alive for 122 days of the rental period. As Roberts was alive for 122 days of the 365-day rental period, 122/365 of the $2,000 is treated as IRD and the remainder of the rent is treated as income of the estate.

Cash rents are included in the landowner’s final income tax return even though the rental period does not end until after the landowner's death.

If the administration of the decedent's estate is completed before the income is received and the estate transfers the right to a beneficiary who ultimately receives the income, the beneficiary reports the income in the year in which he or she receives it.

Example: If Joe Walton owns and operates a tree farm as a cash basis taxpayer, he reports proceeds from the sale of timber in the year when he receives it. If a sale is made before his death, but paid after his death, the payment is treated as income in respect of a decedent by Joe’s estate. If the estate does not collect the bill during its period of estate administration and transfers the right to collect the debt to Joe's heirs, the heirs will report the income in the year they receive payment on the debt.
In filing these returns, the personal representative is entitled to take a full personal exemption and standard deduction even though the taxpayer was not alive for the full tax year. If a spouse survives the decedent and chooses to file a separate tax return that itemizes deductions, the decedent's final return must also itemize its deductions. Amounts withheld from the decedent's income in the final year are reported on the decedent's final return and credited against the final year tax. If any unfiled returns or the final year return generate a refund, the person filing the return, other than a surviving spouse filing a joint return, must file a statement of claim to the refund due. This may require filing an IRS form on which the claim is made or sending proof of the individual's status that gives the person a legal basis for making the claim.

2. **Income Tax Status of the Estate**

The second income tax issue that arises from an individual’s death is the creation of a new taxpayer: the decedent's estate. These provisions are sometimes referred to as the income tax liabilities of a fiduciary, which refers to the personal representative of the estate. Some of the first decisions that a personal representative should take after being appointed is to apply for a federal employer identification number (EIN) for the estate and select the best tax year for the estate. This enables all agencies or individuals who file IRS form 1099 to properly report income to the estate rather the deceased taxpayer or the personal representative. Obtaining a federal employer identification number is accomplished either by mail or by telephone. A personal representative of a Pennsylvania resident decedent can get an EIN immediately by calling the Internal Revenue Service Center that serves the representative’s area. Internal Revenue Service employers will assign the EIN to the personal representative who completes IRS form SS-4 indicating the assigned number on the form, and then sends it to the IRS Service Center that serves your area.

Under federal income tax rules, the estate is entitled to deduct from its reportable income all distributions of income, to the extent of the estate's distributable net income, or DNI. When an estate distributes tangible personal property to residuary heirs under a will or trust, these transfers carry out DNI to the heirs unless the payments are paid in less than four installments and are in satisfaction of a bequest of a specific sum of money or specific items of property.

In addition to income in respect of a decedent, the decedent's estate reports income it receives as interest on invested estate assets, gain or loss on the sale of assets, and income from ongoing business operations. As a separate taxpayer, the estate pays federal income taxes at rates that are somewhat different from those paid by individual taxpayers.

**Example:** For 2002 tax purposes, income up to $1,850 is taxed at the rate of 15% of the taxable income; income over $1,850 but less than $4,400 is taxed at the rate of $277.50 plus 27% of taxable income over $1,850. Income over $4,400 but less than $6,750 is taxed at the rate of $966.00 plus 30% of taxable income over $4,400. Income over $6,750 but less than $9,200 is taxed at the rate of $1,671 plus 35% of the excess over $6,750. Income over $9,200 is taxed at the rate of $2,528.50 plus 38.6% of the excess over $8,450.
Estates are entitled to a $600 exemption from income tax that allows estates with little or no income to avoid the tax entirely. This exemption is available throughout the period of estate administration, but is not available in the tax year in which the estate administration ends.

Living trusts are entitled to an exemption of $300 if they are required to distribute all income currently or $100 if distribution of income is discretionary with the trustee.

The general theory of estate taxation treats an estate as a conduit that passes income and deductions to heirs who then report it on their personal returns. In the final year of the estate's administration period, any excess losses or deductions that the estate has accumulated during the period of administration can be passed on to the beneficiaries of the estate who bear the burden of the excess deductions or losses. These beneficiaries can then use the losses or deductions in their personal tax situations.

If an estate sells assets acquired from the decedent during the course of the estate administration, it calculates gain or loss on the sale. The basis used to calculate gain or loss is the date of death value of the asset, or the value of the property on the alternate valuation date, if the estate elects to take advantage of the alternate valuation. If an estate distributes assets that appreciate in value during the estate administration to satisfy a bequest of money, the distribution triggers recognition of the excess value of the property over the value as of the date of death.

3. Basis of Assets Passing to Heirs From a Decedent

A third income tax concern deals with the tax situation of the heirs who receive the property from a decedent. The importance of this consideration is the income tax impact of applying the basis rules. If a person inherits property with a low basis and a high market value, then significant income taxes can be saved when the recipient of the property sells it in the future. Having a low basis and high fair market value can mean considerable income taxes when property is sold. Traditionally, people planning the transfer of their estates considered the basis changes that occurred when property was given away during lifetime and compared to passing the same property through an estate.

*Estate of people who die before January 1, 2010*

Property that passes to an heir from a decedent receives a step-up in basis to its value as of the decedent's date of death. If an estate elects an opportunity to value assets at the value they have in their particular use, that value, rather than the fair market value as of the date of death, becomes the basis of the assets that are specially valued and passed to other heirs. If an estate’s land assets are subject to a qualified conservation easement transferred by the owner during the owner’s lifetime and the estate excludes a portion of the value of the land subject to the conservation easement, when the owner dies the basis of the land will not be adjusted to the extent that the value of the property was excluded from the estate.

In comparison to the income treatment of the basis of assets that pass through an estate, if an owner gives property to someone during their lifetime, the recipient receives the original owner's
basis in the property. When the original owner dies after the gift is made, the death has no effect on the tax basis of the asset in the hands of the recipient. When the recipient later sells the property, the potential for capital gain or loss from the sale of the asset is real. A special rule applies in the case of a transfer of property to a recipient who dies within one year of receiving appreciated property and then provides that the property pass back to the original owner after the recipient’s death. Under the general rule, the transfer back to the original owner increases the basis to the value at the date of the first recipient's death. However, the special rule replaces the general rule with one that sets basis as the value in the hands of the original owner who first gave away the property. This special rule prevents a property owner from gaining the advantage of a stepped-up basis in property by transferring it to someone who is near death and who will pass the property back to its original owner.

In the case of property owned jointly by husbands and wives, the same step-up rules apply at the death of the first spouse. If the surviving spouse can establish the value of the jointly owned property at the first spouse's death, the surviving spouse can step up his or her basis in the property.

Example: John and Mary purchase property for $30,000 which they own as tenants by the entirety. The funds to purchase the property come from both John and Mary. When Mary dies the property is appraised at $90,000. As John becomes the owner of Mary's one-half interest as the surviving tenant by the entirety, John's new basis in the property is $15,000 from his one half of the original purchase price plus $45,000 which represents Mary's one-half interest transferred to John. John's new stepped-up basis is $60,000 after Mary's death. If John and Mary are joint owners of the property, but are not husband and wife, then a similar adjustment to the surviving owner's basis can be made, but it will be necessary to determine the exact proportion of the purchase price that each paid.

Estates of people who die after December 31, 2009

The rule that allows for a step up in basis of property that passes to heirs after an owner’s death will not apply to estates of people who die after December 31, 2009. Instead of an increase in basis, the basis of property received by heirs will be treated as if the transfer to the heirs were a gift. The basis of the property will therefore be the lesser of the adjusted basis of the decedent or the fair market value of the property as of the date of death.

To offset this change in the income tax basis of property, two opportunities are available that allow property owners to have a selective increase in basis for some property. The first opportunity allows an increase in basis of up to $1.3 million to be applied to property passing through an estate. This will allow a typical landowner to allocate the increase to property passing to specific heirs. If the decedent’s basis in the property is less than $1.3 million, then the heirs will have the benefit of the increase in basis. In the case of decedents dying after December 31, 2010, the $1.3 million basis increase will be adjusted in multiples of $100,000 for cost of living increases.
In addition, a second opportunity exists if the property that is transferred is considered to be “qualified spousal property.” This property is property that passes to a spouse as “outright transfer property” or as “qualified terminable interest property.”

Outright transfer property requires that the property pass to a surviving spouse without restrictions or conditions that could result in the transfer to the spouse being revoked, failing, or terminating. A typical example of such a condition would be to revoke a gift to a spouse who remarries. Conditions that require a spouse to survive for the short period of up to six months after the deceased owner’s death will not be treated as conditions that can revoke a transfer to the surviving spouse.

Qualified terminable interest property is property that passes from a decedent and in which the surviving spouse has a qualifying income interest for life. Such an interest is one in which the spouse is entitled to all the income from the property, payable at least annually, and no other person has the power to appoint any part of the property to another person other than the surviving spouse.

If the property passing to the spouse meets these definitions, then the basis of property passing to a spouse can be increased by up to $3 million. If the property passing to the surviving spouse is jointly owned by the spouses, or is held under community property laws, the deceased spouse will be considered to be the owner of a 50% interest in the property. In cases where the decedent is a joint owner of property with people other than a spouse, the deceased owner will be considered the owner of the property to the extent of the consideration furnished by the deceased owner. A decedent who owns property in a qualified revocable trust will be considered the owner of the property. Under the amending legislation, these changes to the basis rules will expire after 2010 and the current rules will return.

D. State Inheritance Tax

State residents, and non-residents who own real or personal property in the state, may face a state inheritance tax on the transfer of property following the owner's death. The following discussion is couched in terms of a typical state inheritance tax approach and it provides background for the more detailed discussion that follows. The discussion is intended to be representative of what might be found in the project states, and is general.

**Tax Rates**

The typical state inheritance tax is imposed at one of more different rates where the rates may vary according to designated factors, such as the dollar value of the property transferred or the family relationship between the deceased person and the person to whom the property is transferred. Tax-free transfers may include transfers to recognized charities; to federal, state, or local governments; to a surviving spouse; transfers of life insurance proceeds paid to named beneficiaries; social security benefits; and veterans benefits.
Transfers taxed at the lowest tax rate imposed include transfers to decedent's grandparents, parents, lineal descendants, and husband or widower of child. Lineal descendants for inheritance tax purposes include natural children and their descendants, and adopted children and their descendants. Stepchildren and their descendants would be treated as natural children of the natural parent, but may not be treated on the same basis as natural children when it comes to determining if these children are lineal descendants of the stepparent.

Transfers taxed at one or more higher rates include transfers to other persons or entities who are not taxed at either the tax-free or the lower percent tax rate, such as transfers to decedent's brother, sister, aunt, uncle, nephew, niece, other family members, and all non-family members.

Most states do not impose a tax on gifts and other property given away during lifetime, but such transfers might be considered in the overall calculation of inheritance tax. For example, in Pennsylvania if property given away to any person is valued at more than $3,000 at the time of the gift and the person giving property away dies within one year after giving it away, the value of the gift in excess of $3,000 may be subject to inheritance tax in some states. The $3,000 figure applies to gifts made to separate individuals without limit as to the number of individuals. If such a tax provision exists in the state where the owner resides, lifetime gift decisions must consider the size of the gift, the health of the gift giver and the consequences that surround the decision to make the gift. In some states an owner’s intention to avoid inheritance taxes as the reason why the gift was made is irrelevant to the question of including certain gifts in the calculation of inheritance tax.

In determining whether a gift is made, the concept of gift includes transfers of valuable property where the person who transfers the property does not receive valuable consideration in return for the gift. In this sense a gift can be considered complete when nothing is given in return, or partial when some value is received in return for the property, but the value received is less than the value of what is transferred. For additional details, please refer to Chapter VII where the concept of a gift is discussed.

Provisions of the inheritance tax law may also affect lifetime transfers where the original owner does not give up complete control of the property. These situations include transfers that are restricted so that the recipient is unable to immediately use, possess, or enjoy the property, the original owner reserves the right of the right to use the property during his or her lifetime, or the original owner reserves the right to alter, amend, or revoke the gift. In these cases, although the property may be designated to be received by a particular person, it may be subject to inheritance tax in the deceased owner's estate.

Property jointly owned by husbands and wives is generally not subject to state inheritance tax when one spouse dies and the other spouse receives the deceased spouse's share. If joint owners are not husband and wife, the transfer of a fractional share to the surviving joint owner may be subject to inheritance tax at the inheritance tax rate determined by the relationship between the deceased and surviving owner(s). The amount subject to tax is equal to the fractional share of the property that represents the deceased owner's share passing to the surviving owners.
Property subject to inheritance tax is included at its fair market value, which is generally considered to be the value that a willing and able buyer would pay to a willing and able seller of the property. In many instances this value is determined by the market value of the item. Real estate values are determined by real estate appraisals or from sales of the property during the estate administration period where the selling price can generally be used as its value.

Land used in special uses may qualify for special value treatment under some state laws. To qualify for this special valuation land must meet the statutory conditions and comply with any post-death land use restrictions in order to continue to have the benefit of the special value treatment.

State inheritance tax is generally due within a fixed period after the death of a resident or non-resident who owns property subject to tax.

Estates whose assets include small business interests may have the opportunity to elect an installment payment arrangement to pay the inheritance tax on the small business interest. This may allow the heir who continues the business to do so without fear of having to sell the business to pay inheritance tax.

E. State Estate Tax

In addition to an inheritance tax, some states provide for an estate tax that is limited in its scope and application. In a number of other states, this estate tax is the only tax that applies to the transfer of property after an owner’s death. This tax generally applies only to estates that are subject to federal estate taxes as explained below.

In the calculation of federal estate tax liability, every estate is entitled to take a credit against the tax due for state death taxes paid by the estate. The amount of the state death tax credit is calculated according to a graduated rate schedule that starts at a rate of 0.8 percent and increases to a maximum rate of 16 percent. The credit is calculated by multiplying the adjusted taxable estate by the appropriate rate for the size of the estate. Beginning in 2002, and continuing until 2004, this federal credit will gradually be reduced. For estates of people dying after December 31, 2004, the state death tax credit will no longer apply. In its place a deduction for the amount of inheritance and estate taxes paid will apply. The law that repeals the state death tax credit is scheduled to expire after 2010 when the current law will return.

States impose an estate tax to recover the excess amount of any allowable death tax credit over the amount of inheritance tax actually paid. As the federal credit is gradually reduced, states that relied on recovering the amount of the credit will be affected. For instance, if the amount of the credit is greater than the amount of inheritance tax paid, the state tax collects this difference as estate tax. If the inheritance tax paid is greater than the amount of the death tax credit, no estate tax is generally due. If a deceased person has property in more than one state, the value of the person’s property in one state is compared to the value of the entire estate. This ratio is then applied to the state death tax credit to determine the amount that will be compared to the inheritance actually paid to that particular state. If the amount of state inheritance tax paid does
not exceed the amount determined by applying the above ratio, then the state inheritance tax applies to the difference. Recognizing that the state death tax credit allows estates that are subject to federal estate taxes to reduce these taxes, some states have made the state estate tax their only tax that applies to the transfer of property after a person’s death.

F. Federal Estate Tax

The federal government imposes an estate tax on the transfer of property after a property owner's death. This tax is characterized as an excise tax, as it is a tax that applies to the privilege of transferring property after death. This compares to a transfer tax that is based on the value of property that is transferred to someone. Conceptually, both taxes are triggered by a property owner's death. In practice and application, however, the taxes differ.

Unlike the inheritance tax that may have few tax rates, the federal estate tax is calculated according to a graduated rate schedule that starts at a rate of 18% on the first $10,000 subject to tax and increases to a maximum tax rate of 60% of those assets between $10,000,000 and $21,595,000. The maximum rate applies to estates of individuals who died before January 1, 2002. The complete rate schedule for this situation is described below.

For estates of people who die after December 31, 2001 the maximum tax rate will be 50% of taxable assets that exceed $2.5 million. Estates of people who die between 2003 and 2009 will face a gradual reduction in the maximum tax from 49% to 45% on assets that exceed $2.5 million. Estates of people who die after December 31, 2009 will not face an estate tax as it will not apply to estates of people who after that date. Remember, however that Congress has included in the law the statement that all amendments made in 2001 will not apply to estates of decedents dying after December 31, 2010. Therefore, under the 2001 amendments, the repeal of the federal estate tax will occur only during the year 2010.

Federal estate tax and federal gift tax also incorporate another concept known as the generation skipping transfer tax, or "GSTT". GSTT is designed to prevent the tax-free transfer of property from one generation to a generation of beneficiaries who are more than one generation below the generation of the person making the gift. Examples of these gifts are a gift from a grandparent to a grandchild or from an individual to someone who is at least two or more generations (or at least 37½ years) younger than the person making the gift. Transfers that are subject to GSTT include direct transfers by gift or inheritance, transfers at the termination of a trust, or distributions for the benefit of a grandchild from the income or principal of a trust. In cases where an owner wishes to make a gift to a grandchild whose parent has previously died, the grandchild moves up in generational rank to take the level of their deceased parent; such transfers avoid GSTT. GSTT is a separate tax from any estate or gift tax that is otherwise applicable. Under the 2001 amendments to the estate tax law, the generation skipping transfer tax provisions do not apply to transfers that occur after December 31, 2009.
<table>
<thead>
<tr>
<th>Amount Subject to Tentative Tax</th>
<th>Tax on Amount in Column A*</th>
<th>Tax Rate on Excess Over Amounts in Column A*</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 10,000</td>
<td>$ 1,800</td>
<td>18%</td>
</tr>
<tr>
<td>20,000</td>
<td>3,800</td>
<td>22%</td>
</tr>
<tr>
<td>40,000</td>
<td>8,200</td>
<td>24%</td>
</tr>
<tr>
<td>60,000</td>
<td>13,000</td>
<td>26%</td>
</tr>
<tr>
<td>80,000</td>
<td>18,200</td>
<td>28%</td>
</tr>
<tr>
<td>100,000</td>
<td>23,800</td>
<td>30%</td>
</tr>
<tr>
<td>150,000</td>
<td>38,800</td>
<td>32%</td>
</tr>
<tr>
<td>250,000</td>
<td>70,800</td>
<td>34%</td>
</tr>
<tr>
<td>500,000</td>
<td>155,800</td>
<td>37%</td>
</tr>
<tr>
<td>750,000</td>
<td>248,300</td>
<td>39%</td>
</tr>
<tr>
<td>1,000,000</td>
<td>345,800</td>
<td>41%</td>
</tr>
<tr>
<td>1,250,000</td>
<td>448,300</td>
<td>43%</td>
</tr>
<tr>
<td>1,500,000</td>
<td>555,800</td>
<td>45%</td>
</tr>
<tr>
<td>2,000,000</td>
<td>780,800</td>
<td>49%</td>
</tr>
<tr>
<td>2,500,000</td>
<td>1,025,800</td>
<td>53%</td>
</tr>
<tr>
<td>3,000,000</td>
<td>1,290,800</td>
<td>55%</td>
</tr>
<tr>
<td>10,000,000</td>
<td>5,140,800</td>
<td>60%</td>
</tr>
<tr>
<td>21,040,000</td>
<td>12,097,800</td>
<td>55%</td>
</tr>
</tbody>
</table>

The flat rate tax imposed under the GSTT is equal to the highest federal estate tax rate, which in 2002 is 50% of taxable transfers. Individuals have a $1,100,000 GSTT exemption (for 2002) that they can apportion among several transactions. For estates of decedents and generation skipping transfers after December 31, 2003, the GSTT exemption amount will be equal to the applicable exclusion equivalent of the unified credit that is discussed below. Husbands and wives have their own exemption amount they can apply to obtain maximum results for their estate plans. In addition to the available exemptions, present interest gifts that qualify for the
annual exclusion from federal gift tax and tuition and medical expense exclusions from federal gift tax, which are explained below, are also exempt from GSTT.

Federal estate tax is due within nine months of an owner's death. The estate may petition for an extension of time to file the return, but interest on the unpaid tax continues to accrue during the extension period. In the case of estate taxes on active closely-held business interests, opportunities are available to pay the estate tax on the business interest in installments first of interest and then principal and interest for up to 14 additional years. The purpose of the installment payment arrangement is to allow a closely held business to continue operation without fear of having to sell the business to pay federal estate tax. A more detailed discussion of federal estate tax payment obligations and opportunities is found in Chapter VI.

Although the federal estate tax once was a formidable obstacle to individuals who wished to eliminate federal estate taxes in their estate plans, several simple planning opportunities have been available to property owners to manage the impact of the tax on the majority of estates. The following discussion describes these opportunities.

1. The Exclusion Equivalent to the Unified Credit Against Federal Estate and Gift Tax

The first of these planning opportunities is the exclusion equivalent of the unified credit which an owner has and can apply against federal estate tax liability in 2001. The exemption equivalent is $675,000 in 2001. This exclusion equivalent is scheduled to increase until it reaches its maximum amount of $3.5 million in the year 2009. In 2010, the federal estate tax law is repealed. After 2010, the repealing amendments expire and the law reverts to the form in which it would be under the law before the amendments. The following chart converts the credit to the amount of exclusion that is equivalent to it.

<table>
<thead>
<tr>
<th>Year of Death or Gift</th>
<th>Exclusion Equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$675,000</td>
</tr>
<tr>
<td>2002</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>2003</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>2004</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>2005</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>2006-2008</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>2010</td>
<td>Tax is repealed</td>
</tr>
<tr>
<td>2011 and After</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Each resident citizen taxpayer is entitled to this exclusion equivalent to the credit, but there are no current opportunities to allow owners to transfer an unused portion of the credit to another taxpayer, such as a spouse or family member. Deceased individuals who are neither U.S. citizens nor U.S. residents, but who own property in the U.S. subject to federal estate tax at their death are entitled to a reduced credit against federal estate tax set at either the minimum credit
amount of $13,000 or a higher amount set by treaty between the U.S. and the decedent's country of citizenship.

The significance of the exclusion equivalent is that it determines whether the estate is subject to federal estate taxes. If the decedent's gross estate does not exceed the amount of property that, if subject to tax, would equal the amount of the exclusion available to the estate, then federal estate tax is not an issue in the transfer of that decedent's property.

Example: If a decedent's estate in 2002 has the full exclusion equivalent available, and the decedent's gross estate does not exceed $1 million, the decedent's estate need not be concerned with federal estate tax. If the unified credit has been reduced through use of the credit to offset gift tax arising from taxable gifts, the total of all adjusted taxable gifts made after December 31, 1976 is deducted from the $1 million figure. In addition, any portion of the specific gift tax exemption of $30,000 for gifts made between September 8, 1976 and December 31, 1976 used will further reduce the $1 million figure. For estates of decedent dying in later years, the exemption equivalent will increase.

In the above examples a crucial element is the concept of a gross estate for federal estate tax purposes. Please refer to the detailed discussion of this concept in Chapter VI.

2. The Unlimited Marital Deduction

In general

A second estate planning opportunity is provided by the estate tax marital deduction. Under this concept, one spouse can transfer property to his or her surviving spouse free of federal estate tax. The amount of the transfer is unlimited and enables the owner to pass property to his or her surviving spouse. Property that passes to a surviving spouse as surviving tenant by the entirety, as beneficiary of a will or insurance policy, or as the beneficiary of a retirement plan may qualify for the marital deduction if the surviving spouse has the unrestricted or unqualified right to use, possess or enjoy the property.

The Terminable Interest Rule

If the spouse’s right to property can be revoked by passage of time, a specific event, or the failure of an event to occur, the marital deduction may not be allowed for the transfer. Examples of these events include re-marriage or the failure to support a designated family member. These transfers are considered to be terminable and ineligible for marital deduction treatment. If a spouse’s right to receive property from a deceased spouse is conditioned on surviving for a period of time that is less than six months, such a condition will not be considered a terminable interest if the spouse survives for the designated period. The following discussion describes a
major exception to the terminable interest rule, known as “qualified terminable interest property.”

**Qualified Terminable Interest Property**

Certain transfers involving property in which the spouse is given only a life estate (refer to chapter IV) can elect marital deduction treatment as an exception to the rule that ordinarily denies the deduction for such transfers. These transfers are known as "qualified terminable interest property" or "QTIP’s". To meet QTIP requirements, the transfer to the surviving spouse must be a qualifying income interest for life. Such an interest provides that the surviving spouse is entitled for life to all of the income from the property, payable at least annually. No person, including the surviving spouse, has a power to appoint any part of the transferred property to any person other than the surviving spouse during the surviving spouse's life. Any power over the property transferred that is retained must be exercisable only at or after the spouse's death.

*Example: Harold Wilson and his wife Hattie own several tracts of land in their separate names. In Harold's will he provides that one of his separately owned tracts is to be placed in a trust and Hattie is to receive all of the income from the trust during her lifetime, payable to her quarterly. After Hattie's death, the trustee is directed to distribute the trust property to Harold's children Herbert and Harriet. Hattie's interest in the trust is a qualifying income interest and the trust arrangement qualifies for the marital deduction.*

If the QTIP election is made, the qualified terminable interest property will be included in the surviving spouse's estate at death even though it will pass to the children specified by the first spouse’s will. This particular concept allows a person to establish a fund to benefit a surviving spouse for life and gain marital deduction treatment without losing the ability to direct the balance in the fund when the surviving spouse dies.

**Taxes and Expenses**

Another situation in which eligibility for the marital deduction is an issue involves payment of estate expenses. If any portion of the property set aside for marital deduction treatment is used to pay estate or inheritance taxes, the portion used does not qualify for the marital deduction. Therefore, many estate plans calculate the amount of the marital deduction according to a formula that takes these expenses, as well as other factors, into consideration to avoid the loss of some or all of what was thought to be an available deduction.

**Effect of the Marital Deduction**

The effect of the unlimited marital deduction, for example, is to defer federal estate taxes from the estate of the first spouse to die to the estate of the second spouse. As a deferral vehicle, the deduction delays payment and collection of the tax to some future time. If the property is transferred or disposed of by the surviving spouse before death without incurring federal gift tax,
then the transferred property escapes federal estate tax. If the property increases in value prior to the surviving spouse's death, federal estate taxes may actually be higher.

A second factor concerning use of the marital deduction is its impact on use of the unified credit in the estate of the first spouse to die. If nearly all of an owner's property qualifies for marital deduction treatment at the death of the first spouse, then little if any of the deceased spouse's unified credit will be used at that time, since little if any federal estate tax will be generated in the first spouse's estate. In the calculation of federal estate tax, marital deductions are applied before determining the amount of the taxable estate. Therefore, the deduction can result in a very small taxable estate and little or no estate tax to which the unified credit can be applied. Since the unused portion of the unified credit cannot be transferred to anyone else, the unused portion and the property that could have passed tax-free under it are lost.

In the estate of the second spouse, where marital deduction treatment eliminated federal estate tax at the death of the first spouse, the second spouse's estate can use his or her own unified credit to offset federal estate taxes. Without a marital deduction to reduce the size of the taxable estate, the estate of the second spouse faces a greater probability of being subject to federal estate tax. To gain the greatest benefit from the unified credit and the marital deduction, coordination should be made between property ownership and post death transfers in order to fully utilize each credit in the estate of each spouse, thereby doubling the size of property that can pass estate tax free.

3. **State Death Tax Credit and Credit for Tax on Prior Transfers**

In addition to the unified credit, federal estate tax law provides for a credit for state death taxes paid and for taxes paid on prior transfers that occur shortly before another taxable transfer occurs. The state death tax credit is based on a percentage of the adjusted taxable estate for federal estate tax purposes. The amount of the credit increases according to the size of the adjusted taxable estate. The tax rate schedule for estates of persons who die in 2001 is shown below.

Beginning in 2002, and continuing until 2004, this federal credit will gradually be reduced by 25% in each year. That means that for estates of people dying after December 31, 2004, the state death tax credit will no longer apply. In its place, the estate will be given a deduction for the amount of inheritance and estate taxes paid.

The credit for federal estate taxes paid on prior transfers applies to situations where the decedent, shortly before death, received property in a transaction subject to federal estate tax when it was transferred to the decedent. In other words it applies to property transfers through two estates over a short period of time. For the credit to apply, the first taxable transfer must be within two years before and ten years after the current decedent's death.

The credit for tax on prior transfers considers the portion of the current decedent's estate that was subject to federal estate tax in an estate that transferred the property to the decedent. If the death of the current decedent occurred two years before or two years after the death of the decedent
<table>
<thead>
<tr>
<th>Adjusted Taxable Estate</th>
<th>Amount of Credit</th>
<th>Rate on Excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 40,000</td>
<td>$ 0</td>
<td>0.8%</td>
</tr>
<tr>
<td>90,000</td>
<td>400</td>
<td>1.6%</td>
</tr>
<tr>
<td>140,000</td>
<td>1,200</td>
<td>2.4%</td>
</tr>
<tr>
<td>240,000</td>
<td>3,600</td>
<td>3.2%</td>
</tr>
<tr>
<td>440,000</td>
<td>10,000</td>
<td>4.0%</td>
</tr>
<tr>
<td>640,000</td>
<td>18,000</td>
<td>4.8%</td>
</tr>
<tr>
<td>840,000</td>
<td>27,600</td>
<td>5.6%</td>
</tr>
<tr>
<td>1,040,000</td>
<td>38,800</td>
<td>6.4%</td>
</tr>
<tr>
<td>1,540,000</td>
<td>70,800</td>
<td>7.2%</td>
</tr>
<tr>
<td>2,040,000</td>
<td>106,800</td>
<td>8.0%</td>
</tr>
<tr>
<td>2,540,000</td>
<td>146,800</td>
<td>8.8%</td>
</tr>
<tr>
<td>3,040,000</td>
<td>190,800</td>
<td>9.6%</td>
</tr>
<tr>
<td>3,540,000</td>
<td>238,800</td>
<td>10.4%</td>
</tr>
<tr>
<td>4,040,000</td>
<td>290,800</td>
<td>11.2%</td>
</tr>
<tr>
<td>5,040,000</td>
<td>402,800</td>
<td>12.0%</td>
</tr>
<tr>
<td>6,040,000</td>
<td>522,800</td>
<td>12.8%</td>
</tr>
<tr>
<td>7,040,000</td>
<td>650,800</td>
<td>13.6%</td>
</tr>
<tr>
<td>8,040,000</td>
<td>786,800</td>
<td>14.4%</td>
</tr>
<tr>
<td>9,040,000</td>
<td>930,800</td>
<td>15.2%</td>
</tr>
<tr>
<td>10,040,000</td>
<td>1,082,800</td>
<td>16.0%</td>
</tr>
</tbody>
</table>

who transferred the property, the credit for prior transfers is 100% of the federal estate tax that is attributable to the property transferred to the current decedent. If death of the current decedent occurs more than two years after the death of the decedent who transferred the property, the credit for tax on prior transfers is 80% of the federal estate tax if death occurs within the third or fourth year; 60% if death occurs in the fifth or sixth year; 40% if death occurs within the seventh or eighth year and 20% if death occurs within the ninth or tenth year.

G. Federal Gift Tax

In addition to the Federal Estate Tax, the Internal Revenue Code imposes a tax on lifetime transfers of money or property through the vehicle of a gift. In the legal sense, a gift is the transfer of property for less than full and adequate consideration in return. As mentioned in
Chapter VII, a gift can be whole, as in the case where no consideration is offered in return for the gifted property, or partial, in the case where an item is transferred for consideration that is significantly less than the value of the transferred property.

For a gift to exist in the gift tax sense several factors must be in place. First, the person making the transfer must intend the transfer to be a gift rather than a loan or sale. Second, the owner must give up dominion and control of the gift to the recipient. If control of the property is not transferred, or the owner retains authority to change the disposition of the property either for his or her own benefit or for that of others, a gift of the property is not complete and the owner will retain ownership of the item. Third, the recipient of the property must be willing to accept it. A person cannot be forced to accept another person’s gift and the final requirement of acceptance reinforces that concept.

In the case of gifts between spouses or the creation of a joint interest where only one spouse provides the initial property, federal gift tax law does not tax such transactions as gifts because a gift tax marital deduction is available to the spouses. Creation of joint ownership interests between individuals who are not married to each other may create a gift for purposes of the federal gift tax. To determine if a gift is made several factors are considered. If the joint owners acting alone can sever the joint ownership relationship and withdraw funds from the joint interest, a gift is considered to be made of a fractional share of the joint interest. In the case of a joint bank account in which only one individual has contributed funds, a gift is considered to be made when the recipient of the joint interest withdraws funds from the account for his or her own benefit. When joint interests are terminated during the lifetime of all joint owners and the owners receive their shares of the property, a gift is made to those joint owners who did not contribute a proportional amount to the creation of the joint interest equal to what they receive at the termination.

Federal gift tax also treats "no interest" and "low interest" loans in excess of $10,000 as loans made in return for a promise to repay the borrowed amount and as gifts of the interest that would have been paid on the loan at market rates. If the loan is paid on demand, the amount of the gift is the difference between the interest paid and the interest that would have been paid at market rates. If the loan is repaid over an installment term, the gift is determined by comparing the amount loaned to the present value of the payments to be made under the loan.

For taxable gifts made before January 1, 2010, the federal gift tax rate begins at 18% of the first $10,000 of taxable gifts and ranges up to 55% of taxable gifts in excess of $10 million. For gifts transferred after December 31, 2009, gift tax rates are lowered and begin at 18% of the first $10,000 of taxable gifts and range up to a maximum tax of 35% of gifts over $500,000.

In addition, transfers of property subject to gift tax also have an equivalent exemption that can be applied to the transfer. Before the federal estate tax is repealed for estates of people dying after December 31, 2009, a federal gift tax exemption of $1 million is available to federal gift tax transfers. Taxable gifts made after December 31, 2009 will also be entitled to a credit that will be calculated on the basis of the $1,000,000 exclusion. After 2010, the law that amends the federal gift tax expires and the current gift tax law returns.
If an individual made taxable gifts in prior years, the amount of the credit used in those prior years reduces the size of the unified credit available to the taxpayer in the year of the current gift. When the gift tax is calculated, all prior taxable gifts are added to the current taxable gift. A tax based on the current tax rate schedules is calculated on the total gift and gifts in prior years. The amount of the gift tax due is the difference between the tax on the combined gifts as calculated under current rates and the tax on the prior gifts calculated the same way. The current year equivalent exemption is applied to this difference after it is reduced by any prior credit applied to offset gift tax liability. Taxpayers who made gifts between September 8, 1976 and December 31, 1976 were able to claim a specific exemption from federal gift tax of $30,000. If an individual took advantage of that exemption during their lifetime, 20% of the exemption used reduces the amount of the currently available unified credit.

An unlimited marital deduction is also available in the gift tax law. This enables spouses to make transfers to each other of unlimited amounts of money or property without facing liability for this tax. To achieve the estate plan objective of utilizing the full equivalent exemptions in the estates of married individuals, establishing separately owned property for each spouse that will be subject to tax which the credit will be absorbed by the equivalent exemption is an important step toward that goal.

Federal gift tax liability is an obligation of the person who makes the gift. The gift tax return is due by April 15th of the year after the year in which a taxable gift is made. Calculating the value of taxable gifts requires the taxpayer to determine the fair market value of the gift at the time the gift is made. Neither an alternate valuation date nor a special use valuation opportunity are available for this tax. Although the gift tax requires considerable attention in an estate plan that includes lifetime transfers, it also presents several unique planning opportunities.

1. Annual Exclusion From Gift Tax Liability

The first planning opportunity is in the annual exclusion from gift tax liability. Annually, taxpayers are able to give up to $11,000 in 2002 to any one person, or any number of people, free of federal gift tax. In other words a gift is not considered “taxable” until it exceeds $11,000 to a single person in a calendar year. This annual exclusion amount is subject to adjustment for inflation in increments of $1,000. Therefore, an owner who chooses to limit his or her annual gifts to amounts less than the annual exclusion amount faces neither tax liability nor the obligation to file a gift tax return. Exceeding the annual exclusion amount triggers the obligation to file the return and report all taxable gifts made in the period. For example, a gift of $15,000 will be treated as a taxable gift of $4,000. The exemption equivalent can then be applied against the tax calculated for the gift.

To qualify for the annual exclusion, the gift must be a gift of a present interest, which means the recipient must have the right to immediately use, possess or enjoy the gifted property. If restrictions apply and a present interest is not given, the gift is ineligible for the annual exclusion. Individuals who desire to bestow a gift on a minor often face a difficult decision. A minor child may not be able to legally control the property or may not have the financial experience to do so. Transferring property with restrictions designed to prevent a minor from exercising control may
be viewed as an interest that takes effect in the future rather than the present. How does an
owner give a present interest to a minor who cannot fully use, possess or enjoy the property until
he or she reaches the age of majority? The answer is found in specific gift tax provisions that
identify certain gifts as gifts of present interests. To be considered a gift of a present interest, the
gift must provide that the property will be expended for the benefit of the minor before the
minor's 21st birthday. Any balance that is not expended for the benefit of the minor must pass to
the minor at the minor's 21st birthday, or to the minor's estate if the minor dies before reaching
his or her 21st birthday. Transfers in trust for the benefit of the minor that meet these
requirements and transfers to custodians for the minor under the Uniform Transfers to Minors
Act qualify for the annual exclusion as gifts of present interests.

Spouses have the opportunity to increase the amount of their annual exclusion by electing to
"split the gift" which enables them to treat one-half of all gifts made in the calendar year as being
made by each spouse, even though only one spouse provided the gift property. To qualify for
this treatment, the spouses must be United States citizens, must be legally married to each other
at the time the gift is made, must not remarry during the remainder of the calendar year, and must
consent to the split gift treatment of all gifts made in that year. If spouses choose to split their
gifts in a tax year and a gift to a single individual is above the $11,000 per person per year limit,
a gift tax return must be filed. In filing the return the spouses elect the split gift treatment
thereby raising the annual exclusion amount to $22,000 per person per year.

An important point to consider in making gifts within the limitations of the annual exclusion
amounts is the ability to establish the value of the property at the time the gift is made. In some
cases, a professionally produced appraisal may be needed to establish the value. Since
determinations of value are very subjective, extreme caution should be used in making gifts near
the $11,000 figure or a safety cushion should be used to avoid situations where later challenges
to value of gift result in a determination that the value of the gift at the time it is made is more
than the $11,000 or $22,000 amount.

2. Exclusion for Gifts of Tuition or Medical Expenses

In addition to the annual exclusion opportunity, the federal gift tax provides two other
opportunities to make tax-free gifts that are not limited by the annual exclusion amount. The
first of these is a gift of tuition paid directly to an educational institution on behalf of another
person for education or training provided to the person. In this context, the exclusion is limited
to payments for tuition and cannot be used to offset the cost of books, supplies, residence fees
and costs, lodging or similar expenses which do not constitute direct tuition costs.

The second opportunity is the direct payment to a medical care provider for care provided to
another person. This exclusion can also be used to pay for medical insurance for another
individual. Obligations that will be reimbursed by medical insurance, however, are not eligible
for treatment under this unlimited exclusion.

Each of these unlimited exclusions is in addition to the $11,000 annual exclusion otherwise
available and is applied without regard to the relationship between the donor and the recipient.
H. Student Exercises

**Multiple Choice Questions**

Please read the questions carefully, then select one of the four choices following the question that correctly answers the question asked.

1. Which of the following transfers will be subject to federal gift tax?
   a. The gift of a vehicle worth $7,000.
   b. The gift of real property from a husband to his spouse.
   c. A child's gift of $30,000 to her parents.
   d. A parent's gift of $5,000 to each of her seven children shortly before her death.

2. An exclusion equivalent to the unified credit allows a property owner to transfer property free of federal estate tax. How much will the exemption equivalent of the unified credit be for estates of people who die in 2003?
   a. $1,000,000
   b. $1,500,000
   c. $600,000
   d. $675,000

3. Which of the following tax laws is an issue to be concerned about in making transfers of large amounts of property from a grandparent to a great-grandchild?
   a. State Gift Tax Law
   b. Federal Excise Tax on Excess Accumulations
   c. Generation Skipping Transfer Tax
   d. State Estate Tax Law

4. William and Harriet are two happily married people who are concerned about what will happen to their property after they die. Each owns considerable property in his or her own name, as well as other property that is owned by them jointly. The value of their individual holdings is large enough to trigger application of the federal estate tax. Each person wants to have their own property be transferred to the other if one of them dies and the other person survives. Which of the following estate planning opportunities would enable them to transfer all of their property to their spouse after death without federal estate tax being applied?
   a. The annual exclusion
   b. The credit for prior transfers
   c. The marital deduction
   d. The state death tax deduction

5. Which of the following tax concepts is used in calculating income tax gain or loss on the sale of an item that was received as a gift from the prior owner of the property?
   a. The tax basis of the property in the hands of the person selling it
   b. The exemption equivalent of the unified credit
c. The generation skipping transfer exemption
d. Qualified terminable interest property

Short Essay Questions

Please read the question carefully and then respond to the question that is asked at the end of the situation. Your answer need not be long or involved, but it should be as clear and concise as possible. If you want to refer to important facts in your response, please feel free to do so.

6. Bill and Beth received several gifts of real estate from Bill’s mother and inherited other real estate she owned after her death. In order to raise money to fund the cost of a college education for their four children, Bill and Beth are interested in selling these properties. When the properties received as gifts are sold, how will Beth and Bill's capital gain be calculated? How will the gain be calculated when the inherited properties are sold?

7. The Reddick family has owned a 150-acre tract of forest land in central Pennsylvania for more than 100 years. Currently Ralph and Rita Reddick own the land. Fred and Jayne, their two children, are anxious to acquire the land and Ralph and Rita want to give them the chance to do so as they are considering leaving the land to them in their wills. They are also considering giving some or all of the land to their children during their lifetimes, rather than after their deaths.

Based on these facts, what federal and state issues do you recognize as Ralph and Rita try to decide what to do with their land? What planning opportunities might be available to them to address some of the problems you’ve recognized?

8. Sarah Leigh Shollitz is an elderly woman who has accumulated a significant amount of property, including substantial bank accounts and land holdings. Her doctors told her recently that her heart condition is worsening and her future is not very bright. Perhaps she will live another year or two.

Based on this assessment of her physical condition Sarah has decided to bestow some of her property on her family, which includes several children, grandchildren, and great-grandchildren.

If Sarah were to make gifts of her property today, what tax considerations would she have to consider before making the gifts?