

# **Estate and Gift Tax Basics**

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## A. INTRODUCTION

To most Americans, Death and Taxes seem as constant as the North Star. However, at least as far as estate and gift taxes are concerned, that analogy proves to be not completely true. Like so many aspects of Western Civilization, the estate tax traces its roots back to the innovations of the Roman Empire. The first Roman Emperor, Caesar Augustus, instituted a tax of 5% on certain estates and legacies in order to fund his military campaigns. From that point on, estate taxes have been a revenue-generating component of nearly every Western nation.

In the United States, one of the earliest proposals for an estate tax was made by Theodore Roosevelt in 1906 who argued that “[t]he man of great wealth owes a particular obligation to the State because he derives special advantages from the mere existence of government.” Although Roosevelt’s proposal was rejected, ten years later the estate tax came into being as part of some World War I preparations legislation – the Emergency Revenue Act of 1916.

In Minnesota, the legislature’s first attempt at an inheritance tax was first proposed in 1878.<sup>1</sup> The legislature amended the constitution to remedy this issue, but the Minnesota Supreme Court nevertheless struck down three further attempts by the legislature to enact an inheritance tax. Finally, in 1905, the Minnesota Supreme Court upheld the legislature’s 1904 inheritance tax legislation in *State ex rel. Foot v. Bazille*, 97 Minn. 11, 106 N.W. 93 (1905). In 1931, the legislature added a “pick-up” estate tax – that is a tax that is exactly equal to the amount allowed for a state estate tax credit under the federal estate tax. In 1979 the inheritance tax was replaced by an estate tax that mirrored the federal estate tax. In 1985, Minnesota’s stand-alone estate tax was repealed, leaving only the “pick-up” estate tax. Finally, in 2001, all of

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<sup>1</sup> In *State ex rel. Davidson v. Gorman*, 40 Minn. 232, 41 N.W. 948 (1899), the Minnesota Supreme Court held that this tax was unconstitutional on the grounds that its progressive rate structure violated the requirement of uniformity.

this changed with the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, (“EGTRRA”), discussed in more detail below.

## **B. FEDERAL ESTATE TAX ISSUES**

The Federal Estate Tax is levied against the assets of a deceased person before any property is distributed to the heirs of the deceased. The tax applies to “the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.” 26 U.S.C. § 2001. The value of the gross estate is “the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.” 26 U.S.C. § 2031. The gross estate is not the taxable estate, however many deductions and exclusions are allowed. It is the responsibility of the executor to ensure that all taxes due on the estate are paid. 26 U.S.C. § 2002.

Federal law provides an exclusion amount for every estate, which passes to the heirs “tax-free.” According to the EGTRRA, the exclusion amount increases periodically until 2010 (see chart below). For all deaths occurring in 2010, the entire estate is excluded from taxation. Then, in 2011, the exclusions revert to 2001 levels. The exclusion amounts from 2002 to 2011 are as follows:

<b>In the case of decedents dying during:</b>	<b>The Exclusion Amount is:</b>
2002-2003	\$ 1,000,000.00
2004-2005	\$ 1,500,000.00
2007-2008	\$ 2,000,000.00
2009	\$ 3,500,000.00
2010	Full Estate
2011	\$ 625,000.00

*See* 26 U.S.C. § 2010.

Amounts transferred in excess of the applicable exclusion amount are subject to the following graduated tax rates:

<b>Value of Estate</b>	<b>Tax Rate</b>
\$2,000,000 - \$2,500,000	\$780,800, plus 49 percent of the amount over \$2,000,000
Over \$2,500,000	\$1,025,800, plus 50% of the amount over \$2,500,000

26 U.S.C. § 2001(c)(1).

However, the above rates are currently modified by a progressive phase-down of the maximum tax rates, effective for calendar years 2003 through 2009. 26 U.S.C. § 2001(c)(2).

The following table illustrates the effective phase-down rates by year:

<b>Calendar Year:</b>	<b>Maximum Tax Rate:</b>
2003	49%
2004	48%
2005	47%
2006	46%
2007, 2008, 2009	45%
2010	No estate tax
2011 and beyond	Reverts to 2001 levels

See 26 U.S.C. § 2001(c)(2)(B). Therefore, for calendar years 2007 through 2009, the maximum estate tax rate is capped at 45%. Again, for the year 2010, there is no estate tax.

### **C. STATE ESTATE TAX ISSUES**

An estate tax is also imposed upon the estate by Minnesota law to the extent of the value of the property located in Minnesota. Minn. Stat. § 291.01 *et. seq.* Prior to EGTRRA, Minnesota's estate tax was tied to the federal estate tax system, but has now been decoupled and is calculated independently. It is intended "to obtain for Minnesota the benefit of not less than the maximum credit allowed for state death taxes under the federal estate tax law. . . ." Minn. Stat. 291.03, subd. 2. Currently, Minnesota taxes estates that exceed \$1,000,000.<sup>2</sup>

<sup>2</sup> Although the state estate tax previously operated as a credit, under EGTRRA, the credit for state estate taxes has been gradually phased out. The phasing out began in 2002, when the limit of the credit was cut to 75% of what it originally was. In 2003, the limit was cut to 50%, and then to 25% in 2004. As of 2005, taxes paid on state estate taxes no longer serve as a credit, but rather as a deduction.

## **D. GIFT TAX ISSUES**

### **1. Introduction**

The Federal Gift tax applies to virtually any gratuitous transfer of property, whether the transfer is direct or indirect, and whether the property is real or personal, tangible or intangible. 26 U.S.C. § 2511. A transfer is gratuitous if it is not supported by adequate consideration (even if it *is* supported by some *inadequate* consideration); for cases in which some consideration is paid, “the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift” for tax purposes. 26 U.S.C. § 2512(b).

The taxation of gifts is distinct from the taxation of income, and this difference is important to note. The gift tax is a tax levied against the donor. 26 U.S.C. § 2502(c). The donee or receiver of the gift is not required to pay any tax on gifts received, and the gift is not included in the donee’s income for Federal tax purposes. 26 U.S.C. § 102(a).

### **2. Lifetime vs. Testamentary**

There are a variety of reasons, both tax motivated and non-tax motivated, why a client might want to consider making a lifetime gift, as opposed to a testamentary gift. Among the non-tax motivated reasons are that lifetime gifts can be made with a degree of privacy that often is not possible with testamentary gifts, transferring assets away through lifetime gifts can reduce the probate and administrative costs that occur in executing testamentary transfers, lifetime gifts can transfer assets away so as to protect them from potential claims by creditors, or even reasons as simple as being able to enjoy seeing the donee use and enjoy the gift.

Turning to the tax-motivated reasons, there are several advantages of lifetime gifts. First and foremost, individuals can make gift tax-free gifts of up to \$12,000 a year, each and every year, to an unlimited number of donees (this amount is subject to adjustment for inflation on an

annual basis). If the client is married, his or her spouse can also make such gifts to the same person. Thus, a married couple can effectively make gift tax-free gifts of up to \$24,000 per year to an unlimited number of donees. Another advantage of lifetime gifts is that, if a taxable lifetime gift is made more than three years prior to the donor's death, the taxes paid on that gift are not "brought back into" the donor's estate for purposes of calculating the estate tax.. A third advantage is that any appreciation of the value of the gift that occurs between the date of transfer and the donor's death will not be included in calculating the estate tax. This allows for the removal of highly appreciating assets out of the donor's estate altogether. Transferring money in the form of a gift can also be motivated by income tax considerations. A donor in a high bracket can, subject to limitation, gift away enough of his income to someone in a lower bracket, in order for the donor to move down to a lower tax bracket with lower rates.

The Internal Revenue Code exempts certain types of gratuitous transfers from the gift tax. Most notably, tuition paid to an educational institution for the education of an individual, regardless of the amount or relationship – i.e., the donor and donee do not even have to be related – of the parties (26 U.S.C. § 2518); charitable gifts to individuals who have not yet attained the age of 21 (26 U.S.C. § 2503(c)); payment of medical expenses of a donee – again there is no relationship requirement (26 U.S.C. § 2503(e)); gifts, whether money or property, to a political organization for the use of the political organization (26 U.S.C. § 2501(a)(5)). Aside from exemptions, certain marital and charitable gifts can alternatively qualify as a deduction.

#### **E. GENERATION SKIPPING TAXES<sup>3</sup>**

Prior to the development of the generation skipping transfer tax, (hereinafter "GST tax"), the wealthy were able to avoid estate and gift taxes on transfers to their children by simply

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<sup>3</sup> Under EGTRRA, the generation skipping transfer tax will repeal on January 1, 2010, and then automatically be reinstated on December 31, 2010.

passing the family property on to their grandchildren instead. More popular were transfers to “dynastic trusts” that benefited children, grandchildren, and subsequent generations for as long as would be allowed under the relevant state’s Rule Against Perpetuities. Often, enormous estates and vast fortunes were able to be passed on down through the generations for one-hundred years or longer with no estate or gift tax ever being realized. To combat this situation, the GST tax was enacted.

When the GST tax is implicated, it is imposed at the maximum federal rate<sup>4</sup>, and in addition to the estate or gift tax. Although the GST tax is significant, it can be alleviated, to a certain extent by exemptions.<sup>5</sup>

The GST tax is imposed whenever a generation skipping transfer occurs. A generation skipping transfer occurs in three situations: 1) a taxable termination; 2) a direct skip; and 3) a taxable distribution.

A taxable termination refers to the situation when a non-skip person’s – i.e., the children of the transferor – interest held in trust terminates in favor of a skip person – i.e., individuals that are two or more generations below the transferor. For example, a taxable termination occurs in the following situation: T, transferor, establishes a trust for the benefit of his child, C, during C’s lifetime with the remainder to T’s grandchild, G. Upon the death of C, a taxable termination occurs because the interest of C will completely terminate in favor of G. Direct skips occur when, for example, T makes an outright transfer to G or to a trust that is solely for the benefit of G. Finally, a taxable distribution occurs whenever a trustee with discretion to distribute property

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<sup>4</sup> Under EGTRRA the rate is 45% in 2007, 2008, and 2009. Assuming nothing changes, there will be no GST tax in the year 2010, and then the GST tax will return in 2011 at the rate of 55% - the original rate before EGTRRA was enacted.

<sup>5</sup> Like the GST tax rate, EGTRRA provides for a more “friendly” exemption amount through 2010. Prior to EGTRAA the exemption was \$1,000,000. In 2007 and 2008, the exemption amount will be \$2,000,000, and it will be \$3,500,000 in 2009. As there will be no GST tax in 2010, there will be no need for an exemption in that year. Finally, once EGTRAA expires at the end of 2010, the exemption amount will revert to \$1,000,000.

to either a skip (child for example) or non-skip (grandchild for example) makes a distribution from the trust to a non-skip person.

## **F. INCOME TAX ISSUES**

### **1. Introduction**

It is important to remember that estates and trusts are separate tax-paying entities. Although both estates and trusts are subject to the same income tax rate as are other entities, there are some differences in the computational system. Most important is that they are taxed on income withheld, while income distributed is eligible for a deduction. If this regime were not in place, beneficiaries of an estate or trust would be indistinguishable from shareholders in a corporation, in that there would be double taxation: the income to the estate or trust would be taxed and then the beneficiary would be taxed on distribution just as certain corporations are taxed on the income earned and the shareholders are taxed when they receive dividends.

The general rule of income taxation of estates and trusts is that the estate or trust pays income taxes on amounts of income (earned by the trust or estate) retained, while the beneficiaries pay income taxes on distributions. Thus, taxation only occurs once: 1) if the estate or trust retains the income, the estate or trust is taxed; or 2) if the estate or trust distributes the income, the beneficiary is taxed.

As discussed above, the estate or trust, as a separate taxable entity, is taxed on its income. For example, income to the estate or trust in the form of dividends from stock, interest from bonds, rental income, royalty income, income from the sale of property, or income from a business being carried on by the executor or administrator are all sources of income to the estate or trust that are subject to tax. As a separate entity, the estate or trust also can qualify for deductions that exceed two percent of adjusted gross income of the estate or trust. Expenses that

are incurred solely by reason of administering the estate or trust are deductible in full, regardless of the two percent requirement. The trustee of the trust or executor of the estate has the choice of deducting these expenses either from the income tax return of the estate or trust or from the federal estate tax of the estate or trust. Finally, as mentioned above, the estate or trust can claim deductions for amounts of income distributed to or on behalf of the beneficiaries.

In a trust that allows the trustee discretion on how to deal with income of the trust, the trustee may be able to spread the income among the beneficiaries. When distributions are made, beneficiaries are taxed at their income tax rates. The benefit of this is that if the beneficiaries are in lower tax bracket than the trust, the income of the trust can be shifted to the lower tax bracket, and enjoy the protection of the multiple personal exemptions of each of the beneficiaries. This also has the benefit of using less of the trust assets to pay taxes, leaving more principal in the trust for investment and/or later distribution to beneficiaries. It is important to consider the tax rates applicable at distribution or retention and whether the decision to distribute or retain income is tax efficient for the trust or estate.

## **2. The Final Individual Income Tax Return**

The final income tax year ends on the date of the decedent's death. Thus, if the decedent were to die on February 28, an income tax return would have to be filed for the short year of January 1 to February 28. The due date for the return remains the same, April 15 of the following year.

Things to keep in mind:

- For a cash-basis method, only those income and expenses that have been actually or constructively received while the decedent was still alive are reported on the final income tax return.

- Under an accrual method, the return includes all income and deductions that have accrued as of the date of death;
- Even though the decedent did not live an entire year, he is still entitled to the full amount of standard deductions and personal exemptions;
- The spouse of the decedent can still file a joint return for the year of the decedent's death.