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# Transfer Tax Overview

There are three transfer taxes which tax the gratuitous transfer of property from a person to his or her family members (or others), the estate tax (IRC §§ 2001 et seq.), the gift tax (IRC §§ 2501 et seq.), and the generation-skipping tax (IRC §§ 2601 et seq.) which respectively tax transfers at death, transfers during life, and transfers during life or at death to family members (or others) more than one generation below the transferor (e.g., transfers to grandchildren). The following is a summary overview of these taxes which are considerably more complex than the descriptions provided below.

1. **Estate Tax**. The estate tax essentially has a 40% tax rate although there are some rate brackets before the 40% bracket. IRC § 2001. The threshold before which no tax is payable is now up to $11,180,000 (2018) based on a unified credit exclusion equivalent to the extent the credit is unused at death. IRC § 2010. The tax is due 9 months from death. Property included in a decedent's gross estate gets a basis adjustment (often a step-up) to fair market value (FMV) at death for income tax purposes. IRC § 1014. Utah no longer has a pick-up estate tax after the repeal a number of years ago of the credit for state death taxes. Other states have their own estate or inheritance tax systems.

a. Value. Generally, property is taxed on FMV but this can include valuation discounts. Value is determined at date of death or at the date six months after the date of death, at the election of the personal representative ("PR"). IRC § 2032. Such valuation date election is all or none as to the entire gross estate. IRC § 2032. There are statutory exceptions to certain types of discounts; these exceptions are designed to curtail certain planning techniques based on valuations. IRC §§ 2701 et seq. There are also some provisions designed to allow certain farm and business property to be taxed at lower actual use value rather than at fair market value which uses highest and best use as the standard for valuation. IRC § 2032A.

b. Gross Estate Inclusion Sections. There are a number of Code sections designed to include in a decedent's gross estate essentially all property or rights relating to property held or controlled, directly or indirectly, by a decedent. These sections are:

§ 2031(a) – value of property at death

§ 2032 – alternate valuation – 6 months after death

§ 2032A – special use value for certain real property

§ 2033 – property in which decedent had an interest (typically probate estate assets) (2034 includes dower and curtsey or property in- lieu of those rights)

§ 2035 – certain gifts in 3 years of death (would have been included under2036, 2037, 2038, 2042)

§ 2036 – retained life estate (includes certain retained controls)

§ 2037 – transfers taking effect at death (reversion over 5%)

§ 2038 – revocable transfers (e.g., revocable trusts)

§ 2039 – annuities payable to decedent (to extent of proportion of consideration paid)

§ 2040 – joint interests (generally proportionate, but half between spouses; half of community property)

§ 2041 – powers of appointment (general powers; Delaware tax trap exercise to create a further power)

§ 2042- life insurance proceeds (paid to PR or where decedent had incidents of ownership)

§ 2043 – insufficient consideration (exercise or release for consideration of powers under §§ 2035 to 2038 or 2041 for less than full consideration)

§ 2044 – prior marital deduction property (e.g., where there was a qualifying income interest for life)

§ 2045 – prior interests (§§ 2034-2042 powers whenever made, exercised, or relinquished); § 2046 is a cross reference to qualified disclaimers

c. Deductions. There are deductions used against the estate tax. A state death tax deduction is available in some states that have their own estate or inheritance tax systems, but not Utah, which does not maintain a separate system. IRC § 2058. Expenses, debts, and taxes are deductible. Medical expenses of the last illness can be deducted against the estate tax, unless the estate elects to take as an income tax deduction. Administrative expenses and funeral expenses are also deductible. IRC § 2053. Casualty and theft losses incurred during administration are deductible. IRC § 2054.

There is a very important marital deduction which requires providing a surviving spouse at least a qualifying income interest for life. IRC § 2056. This deduction is unlimited in amount and allows the estate tax on the property to which the deduction applies to be postponed until the surviving spouse's later death. The value of such property remaining at the spouse's later death is included in that spouse's gross estate. IRC § 2044. The standard ways to obtain the marital deduction, besides outright transfers, are to grant a general power of appointment in trust for a spouse or to provide an income interest for life and make the QTIP election on the estate tax return (form 706).

A qualified domestic trust (QDOT) is needed for a gift for a foreign spouse to qualify for the marital deduction. This is to assure that the tax on the property can later be collected on the foreign spouse's second death. IRC § 2056A.

There is also a charitable deduction unlimited in amount which can apply. IRC § 2055.

The marital and charitable deductions will be reduced if the marital or charitable gift is subject to claims and administrative expenses.

d. Tax Calculation. The unified rate schedule for estate and gift tax (top rate 40%) is applied to:

the taxable estate, i.e., the gross estate less deductions, plus

adjusted taxable gifts not otherwise included in the gross estate,

reduced by gift taxes payable at rates in effect at death (not at the time of the gift).

Next, credits are applied against the tentative tax.

The decedent's unified credit is applied to the extent it has not earlier been used against tax on lifetime gifts. To the extent not fully used during life and at death, a surviving spouse may use the DSUE (deceased spousal unused exclusion amount) of the last deceased spouse of such survivor. This "portable" exclusion equivalent amount is in addition to the separate unified credit of the spouse who is the second to die.

There are also some lesser used credits: for a tax on prior transfers to this decedent (10 years before, 2 years after this death) (IRC § 2013), for pre-1977 gift taxes (IRC § 2012), or for foreign taxes paid (IRC § 2014).

e. Planning Tools. Planning to reduce estate tax usually involves certain classic techniques. A credit shelter trust is used to kill tax in decedent's generation. It is funded with property up to the amount of the unused unified credit exclusion equivalent. It is often designed not to have the marital deduction apply, because with such a deduction, the property will be in the surviving spouse's gross estate, potentially pushing that estate high enough to attract a tax it otherwise may not have been subject to. The portability of the DSUE helps ameliorate this situation.

A marital deduction trust is typically used for the rest of the property where the decedent is married. This postpones the tax on this property until death of surviving spouse.

The marital deduction could be obtained by the use of an outright gift, but a trust is generally preferred. The marital trust needs to avoid the terminable interest rule or meet the requirements of a qualified terminal interest property (QTIP) trust. The policy of these rules is to assure the deduction can only be used where the surviving spouse really gets the benefit of the property, and the benefit of the property will not be taken away from the spouse. There are other qualifying conditions as well designed to protect the spouse's rights to the benefit of the property, for example, requiring the spouse to have a right to require unproductive property to be converted to income producing property.

The first classic form of marital trust is a trust that grants the spouse lifetime income with a lifetime or testamentary general power of appointment.

The next classic form is an estate trust with income payable or accumulated and where principal and all accumulated income pass to the estate of the spouse on that spouse's second death. This is not commonly used.

It is very common to use the third classic form, a QTIP trust (qualified terminal interest property). This provides the spouse income for life. An election in the estate tax return must be made as to all or part of the trust. This requires a tax return at the first death but, with the consequent inclusion in the gross estate of the surviving spouse, this also allows property to get a second step up on the second death. A planner could try using the Delaware tax trap to get such inclusion for the surviving spouse without filing a return. The Delaware tax trap essentially treats a special power of appointment as if it were a general power if the special power can be used to grant an additional power of appointment. IRC §§ 2041, 2514(d).

There are various ways to fund the marital trust, in particular, there are variations on a pecuniary funding formula (allocating by dollar values) or on a fractional funding formula (allocating by fractional shares of all assets). A pecuniary formula is generally easier to administer, but if there is income in respect of a decedent (IRD), funding a pecuniary gift in kind is treated as a sale causing previously unrecognized income to be recognized right away. A fractional formula is harder to administer but avoids the problem with IRD. IRD can include Individual Retirement Accounts (IRAs), qualified plans, installment sales, government savings bonds, employee stock options, etc.

The decedent could grant the surviving spouse the power to disclaim from the marital trust into a credit shelter trust for the benefit of the spouse but without any control of that trust by the disclaiming spouse either as trustee or holder of a power of appointment. IRC § 2518. This allows flexibility.

The combination of the two trusts (credit shelter and marital) is still very useful in large estates. Disclaimer trusts are quite useful in moderate estates (e.g., in the $5M range due to reversion to a lower credit after the year 2025).

Portability of the deceased spouse's unused credit is useful (the DSUE); this requires filing of estate tax return on the first death even if not otherwise necessary.

A married couple can cover in excess of $22 Million from estate tax using the unified credits of both spouses.

The estate tax generally is due 9 months from death (even if the return due date is extended). There are, however, some provisions designed to allow payment of tax over time on certain farm, ranch, or small business property. IRC § 6166.

2. **Gift Tax**. Gift tax is unified with the estate tax. The rates and brackets and unified credit apply to both taxes. Gift tax is paid by the donor, but if not paid, the donee may be liable. The amount of gift tax paid is not itself taxed; this is an advantage over the estate tax where the tax itself is taxed. Gift tax is reported on form 709. The unified credit can be used during life against any gift tax. The donee gets a carryover basis in the property given.

a. Gifts. Gifts can be direct or indirect. Some types of gifts:

Transfers for less than fair market value (the difference is a gift);

below market loans;

transfers to closely held organizations;

transfers to joint tenancy ownership other than with a spouse;

exercise of a limited power of appointment where the exercise transfers an interest in property the holder of the power would otherwise have. See Rev. Rul. 79-327,1979-2 C.B. 342; Treas. Reg. 25.2511-1(g)(2).

There are some exceptions where a gift is not taxed, such as direct payments to an education organization for tuition (other tuition programs require the use of the annual exclusion), or direct payments to a medical provider for care (includes insurance premiums). IRC § 2503(e).

b. Annual Exclusion. An annual exclusion of $15,000 per donee (2018) applies where the gift is of a present interest. IRC § 2503(b). Crummy powers of withdrawal are useful with trusts in order to make the transfer into trust the transfer of a present interest. Crummy powers are often allowed to lapse at 5% or $5,000 per year in order to take advantage of the "5 and 5" exception to the definition of a general power of appointment (IRC §§ 2041(b)(2) and 2514(e)). The lapse of a general power can make the holder of the Crummy power a grantor of the trust under the income tax grantor trust rules (IRC §§ 672 et seq.) and thus taxable on part of its income; the 5 and 5 exception helps avoid this income tax result.

Age 21 trusts (IRC § 2503(c)) can also be useful as an exception to the present interest rule, but such trusts end at age 21 and, thus, other trusts lasting longer may be superior in many situations.

c. Tax Determination. There is a cumulative computation of tax where there are prior gifts. A marital deduction applies (including QTIP) (IRC § 2523) and a charitable deduction can apply (IRC § 2522).

Split gifts with a spouse are possible to obtain the use of two annual exclusions even though all the property given is only the property of one of the spouses. IRC § 2513. This requires filing a gift tax return. Joint annual exclusion gifts of high basis property to descendants is a common strategy.

The statute of limitations period does not commence without filing a return with full disclosure and with a qualified appraisal; this is particularly important where discounts are claimed. The return is due April 15 of the following year after the gift is made.

d. Planning. Large gifts in the period 2018 – 2025 may be useful to hedge the bet against the sunset reversion to the $5M (as indexed) credit equivalent in 2026; however, the donor may want to wait until toward the end of the period to see what happens.

In order to get a better step up basis at death, don't give low basis property.

Hedging the order of spouses' deaths with interspousal gifts to get a step-up basis on first death can be useful. It is possible to grant a general power of appointment to the least propertied spouse (e.g., exercisable by will in favor of creditors of the estate but with the consent of a non-

adverse party, but who is not the grantor of the power; a non-adverse party can be an independent person). Formula powers can focus on lowest basis property.

Upstream gifts to parents who are without estate tax concerns to get a step-up basis on a parent's death and pass the property after the death into a trust which is not includable in the estate of the giving child, is another strategy. The death of the parent within one year of the gift can be a problem since in that situation the transfer won't produce a basis step-up. General powers of appointment could be used here, too.

3. **Generation Skipping Tax (GST)**. GST transfers are made directly or through trust to skip persons more than one generation below the donor. IRC § 2613. GST is provided by IRC §§ 2601 et seq. It is reported on form 709 for lifetime gifts or triggering events and on form 706 for gifts or triggering events made at death. Property is valued at fair market value at the time of the generation skipping transfer, but valuation on direct skips is subject to the special valuation rules of IRC §§ 2032 or 2032A relating to certain farm, ranch, or small business property. IRC § 2624(a) and (b). Also, for a taxable termination on death, the alternative valuation date of 6 months after death may be elected. IRC § 2624(c).

The top estate tax 40% rate applies (there are no lower brackets) to arrive at an "applicable rate" determined by application of an "inclusion ratio." IRC §§ 2602 and 2641(a) and (b). The exemption is same dollar amount as the exclusion equivalent for estate and gift tax, but is a separate exemption.

a. Exclusion. There is also an annual exclusion for direct skips similar to that for gift taxes (IRC § 2642(c)(3)(A)), but it requires the donee to have a general power of appointment so the gift will attract the estate tax on the donee's death (IRC § 2642(c)(2)(B)). Further, for direct skips, there is an unlimited exclusion, similar to the gift tax exclusion, for medical and tuition expenses. IRC §2642(c)(3)(B). Spousal split gifts may be used as well for using the annual exclusion. IRC § 2642(c)(3)(A).

b. Triggering Events. The tax is triggered on three events (IRC § 2613): (i) a taxable termination (IRC § 2622) of an interest in trust where all interests are two or more generations lower than the donor (trustee pays tax); (ii) a taxable distribution (IRC § 2621) of income or principal to a transferee two or more generations lower (the transferee pays tax, the trustee files form); and (iii) direct skips (IRC § 2623) to a transferee two or more generations lower (donor pays with gift tax return on lifetime gifts; personal representative pays with 706 for direct skips at death). Direct skips are tax exclusive (like the gift tax) while taxable terminations and taxable distributions are tax inclusive (like the estate tax). Some deductions related to the transfer are allowed for taxable terminations and taxable distributions.

c. Exemption Allocation. Allocation of GST exemption will determine an inclusion ratio. IRC § 2642. The term "inclusion ratio" means the "applicable fraction" subtracted from 1. The applicable fraction is (i) the amount of the GST exemption allocated to the trust or property transferred over (ii) the value of the property reduced by federal or state death tax recoverable from the property and by any estate or gift tax charitable deduction allowed for the property. IRC § 2642(a)(2). The applicable rate of tax is the maximum federal estate tax rate (i.e., 40%) times this inclusion ratio. The result of applying this complex formula is that it is better to have

separate shares with ratios of 1 and of 0, i.e., all taxable or all exempt, than to combine exempt and nonexempt property in a share.

An exempt trust covered by a GST exemption may be a dynasty trust lasting a long time. There are complex rules relating to automatic allocations of the GST exemption if not otherwise allocated by the donor or by the donor's personal representative. IRC § 2632. Retroactive allocations are possible if a non-skip person descendant dies before the transferor. IRC § 2632(d)(1).

There are other complex rules relating to the assignment of generations (IRC § 2651), determining who is the transferor (IRC § 2652), allowing split transfers by spouses, and providing a QTIP special "reverse" election to allow QTIP trust property to be deemed transferred by the first decedent spouse instead of by the surviving spouse. The reverse QTIP election can be useful to allow the first deceased spouse the use of the GST exemption; such exemption is not portable like the estate tax DSUE.