

Chapter 1: INTRODUCTION TO FEDERAL TRANSFER TAXES

Introduction

The federal transfer tax system is comprised of three separate transfer taxes: (1) the federal estate tax; (2) the federal gift tax; and (3) the federal generation-skipping transfer (“GST”) tax. Each of these transfer taxes is imposed on the *privilege* of being able to *transfer* property rather than a tax on the transferred property itself. The federal estate tax covers transfers at death; the federal gift tax addresses lifetime transfers; and the federal GST tax catches transfers to grandchildren and others that would otherwise escape taxation through a loophole in the transfer tax system. The tax rules governing these transfers are highly technical and extremely complex, and the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), discussed below, has complicated an already difficult set of tax rules.

Marginal Rates

Without proper estate planning, the unified transfer tax system can result in a significant loss of

an individual’s assets, including ownership of a family business interest. The marginal tax rates for federal gift and estate tax purposes in effect for 2009 as adjusted by EGTRRA were as shown in the following chart:

TABLE 1

Taxable Amount	Tax Rate
\$10,000 or less	18%
\$10,001 to \$20,000	20%
\$20,001 to \$40,000	22%
\$40,001 to \$60,000	24%
\$60,001 to \$80,000	26%
\$80,001 to \$100,000	28%
\$100,001 to \$150,000	30%
\$150,001 to \$250,000	32%
\$250,001 to \$500,000	34%
\$500,001 to \$750,000	37%
\$750,001 to \$1,000,000	39%
\$1,000,001 to \$1,250,000	41%
\$1,250,001 to \$1,500,000	43%
\$1,500,001 or more	45%

Unified Transfer Tax System

Like most bodies of law, the transfer tax laws have evolved significantly since their inception. Since the Tax Reform Act of 1976, however, lifetime transfers by gift and transfers at death have been taxed under a unified transfer tax system. The purpose of this unified system has been to equalize the treatment of lifetime and testamentary transfers.

Under the unified system, which is "suspended" at this time, a single tax rate schedule applied to transfers for both gift tax and estate tax purposes. The applicable tax rates were progressive, based on an individual's aggregate lifetime transfers and transfers at death. Under 2009 law as shown in the chart above, the maximum tax rate ranged from 18% for transfers of \$10,000 or less to 45% for transfers over \$1,500,000. In addition to the unified tax rate, a cumulative "unified credit" ("applicable credit amount") applied against an individual's transfer tax liability for transfers by gift and at death. For 2009, the applicable credit amount for estate tax purposes was \$1,455,800 (\$345,800 for gift tax purposes), and the applicable exclusion amount (the amount of transferred property exempt from tax by the applicable credit amount) for estate tax purposes was \$3,500,000 (\$1,000,000 for gift tax purposes).

The GST tax was enacted to close a loophole in the unified transfer tax system by approximating the transfer taxes that would have been due if property had been transferred at each generation level. Unlike the estate and gift tax rates, which increased with the value of the property transferred, the GST tax rate was a flat rate based on the maximum estate tax rate (45% for 2009). The GST tax was imposed *in addition* to the estate tax and the gift tax with respect to certain transfers, making it an extremely expensive tax.

Economic Growth and Tax Relief Reconciliation Act of 2001

Pursuant to EGTRRA, for 2010 the federal estate tax and GST tax have been repealed, a carry-over basis regime under Internal Revenue Code ("IRC") § 1022 has replaced the basis adjustment rules under IRC § 1014, and the gift tax rate has dropped to 35%. IRC §§ 2210(a), 2502(a), 2664(c), 1014(f). Subject to Congressional action during 2010, extensive changes to the transfer tax provisions of the Code will again occur in 2011, as discussed below.

EGTRRA contains a sunset provision that eliminates all of the changes made by EGTRRA at the end of 2010. Thus, beginning on January 1, 2011, unless Congressional action in 2010 alters this result, the estate tax rate and applicable exemption amount will return to the levels that existed before EGTRRA. Consequently, the maximum estate, GST and gift tax rates will equal 55%, and the estate and gift tax applicable exemption amounts will equal \$1 million. The GST exemption will be \$1 million, indexed for inflation (it would likely be about \$1,340,000). Estates having a value between \$10 million and \$17.1 million will incur an additional tax of 5%. In addition, the state death tax credit under IRC § 2011 will be restored. To complicate matters further, Congress may take action in 2010 to re-enact the estate tax and GST tax retroactive to January 1, 2010.

Some of the major changes EGTRRA made to the transfer tax system include the following. These changes are discussed in detail in subsequent Chapters in this book.

De-Unification of the Unified Credit

Since 2004, the unified credit against estate tax and gift tax has no longer been unified because EGTRRA has increased the applicable exclusion

TABLE 2

Year of Transfer	Estate Tax Exemption	Gift Tax Exemption	Maximum Estate & Gift Tax Rate
2008	\$2,000,000	\$1,000,000	45%
2009	\$3,500,000	\$1,000,000	45%
2010	Estate tax repealed	\$1,000,000	35% (gifts only)
2011	\$1,000,000	\$1,000,000	55%

amount for estate tax purposes (referred to here as the “estate tax exemption”) while the applicable exclusion amount for gift tax purposes (referred to here as the “gift tax exemption”) has remained at \$1,000,000. The evolution in the estate tax exemption has been since 2008 and is scheduled to be in 2010 and 2011 as shown in TABLE 2.

Although the estate tax exemption and the gift tax exemption differed in amount, these exemptions were still cumulative and worked together to determine an individual’s federal estate tax liability. That is, in 2009, an individual did not have a \$1,000,000 gift tax exemption and a separate \$3,500,000 estate tax exemption. Rather, during life an individual can transfer up to \$1,000,000 without incurring federal gift tax, and, at death, the individual could transfer an additional \$2,500,000 without incurring federal estate tax if the individual had already used his or her \$1,000,000 gift tax exemption. Thus, the aggregate amount that could be transferred during life and at death without incurring federal estate tax was \$3,500,000 in 2009.

Reduction in Estate, Gift and GST Tax Rates & Repeal of Estate and GST Tax

Under EGTRRA, the maximum estate, gift and GST tax rates declined (see chart above) until the repeal of the estate tax and GST tax in 2010. During the scheduled one-year repeal of the estate tax and the GST tax in 2010, the gift tax remains in effect at the top income tax rate of 35%.

Additions to GST Tax Rules

EGTRRA contains additional GST tax relief retroactive to December 31, 2000. These rules are highly technical and add another layer of complexity to the transfer tax rules.

Carryover Basis

Under EGTRRA, beginning in 2010, the current “step-up in basis rule” for determining the basis of inherited property is replaced with a set of complicated “carryover basis” rules that apply even after repeal of the estate tax and GST tax.

Conclusion

More than ever, clients are looking to a myriad of professional practitioners, including attorneys specializing in estate planning, general practice attorneys, financial planners, accountants, banking professionals, life insurance agents, and other advisors, to guide them through these complex transfer tax rules and to provide them with financial, tax, and estate planning advice. Because minimizing taxes is an important goal of these clients, it is imperative that advisors have a detailed understanding of the transfer tax rules. A thorough comprehension of the rules and the effect of EGTRRA on these rules will help practitioners recognize potential issues, identify potential solutions and provide sound planning advice. The following three Chapters discuss in detail the rules governing the federal estate tax (Chapter 2), the federal gift tax (Chapter 3), and the federal

GST tax (Chapter 4). In general, these Chapters cover the transfers subject to the tax; the deductions, exclusions and credits available to offset the tax; the computation of the tax; special rules applicable to the tax; and changes made by EGTRRA. The next two Chapters discuss the valuation of assets for transfer tax purposes (Chapter 5) and the federal income taxation of trusts and estates (Chapter 6). These initial Chapters are intended to give the reader an understandable, yet thorough, discussion of the principal rules governing the transfer tax system and the income taxation of trusts and estates. The balance of the first volume is devoted to a comprehensive

discussion of the numerous planning techniques (Chapters 7 through 17) available to address the otherwise potentially confiscatory gift, estate and GST taxes, the ethical considerations for practitioners (Chapter 18), the duties and liabilities of practitioners and fiduciaries (Chapters 19 and 20), and comprehensive wealth management (Chapter 21). Volume II contains a comprehensive annotated set of will and trust forms that my colleagues at Sonnenschein Nath & Rosenthal LLP have developed and I hope will be useful to you in minimizing or eliminating the transfer taxes discussed in these two volumes.