

# Transfer Taxes, an Introduction

Essentials 2018

The Federal Transfer Tax system is comprised of three taxes: the Estate Tax, the Gift Tax, and the Generation Skipping Transfer (GST) Tax. Unlike the income tax system where a tax is imposed on the value of an asset, in the transfer tax system a tax is imposed on the transfer of wealth from one individual to another. It is entirely possible that an asset may be subject to Federal income taxes in addition to a transfer tax, depending on the type of transaction. Under tax law, the Federal Government exempts a certain dollar amount from transfer taxes – known as the Applicable Exclusion Amount for gift and estate taxes and the GST Exemption Amount for the generation skipping transfer tax.

## How the Federal Estate Tax Works

The federal estate tax applies to assets transferred at death. (Reporting occurs on IRS Form 706.)

- Determining what property is calculated in the gross estate. This included worldwide assets owned at death.
  - Ownership for this purpose is very broad and will even include property that had been given away prior to death, such as life insurance policies that were transferred within the last three years.
  - The marital deduction and charitable deduction eliminates any Estate tax on these transfers. Also, no Estate tax is applied to any administrative expenses, funeral expenses, debt, or cost for administering the estate.
- After deductions, the remainder of the estate is subject to Estate Tax.
- Once the Estate Tax has been calculated, any portion of the client's remaining exclusion amount not used to shelter lifetime gifts from Gift Tax can be used against Estate Tax. So, if the client has not made any taxable gifts during their lifetime, their total applicable exclusion amount remains available for exemption.

**Example:** A widower dies, leaving \$10M to his children. He has not made any taxable gifts. Under the law in place at the time of his death, he had a \$5M applicable exclusion amount available and a 40% top tax rate. In this example, no federal estate tax is due on the first \$5M passing to his children; estate tax will be due on the remaining \$5M at the 40% tax rate.

## How the Gift Tax Works

The gift tax applies to assets transferred during life. (Reporting occurs on IRS Form 709.)

- Current law provides that an annual gift can be made to an individual where no gift tax is due (the "gift tax annual exclusion"), with all gifts to that individual in excess of the annual amount being subject to gift taxation. Additionally, someone else's educational or medical expenses can be paid without being subject to gift taxes.
- Any appreciation after a gift is made is not included in the donor's estate in determining the estate tax.
- The gift tax does not apply to certain transfers to a U.S. Citizen spouse or to transfers to qualifying charities.
- Where a gift is made to someone other than a spouse or charity and where a portion of the gift exceeds or does not qualify for the gift tax annual exclusion or the exclusion for educational or medical expense, such portion is a "taxable gift" subject to Gift Tax.



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- U.S. Citizens do have an “applicable exclusion amount” which they can give during their lifetime in cumulative taxable gifts before any gift tax is actually paid. But note this is linked to the estate tax so any applied to the gift tax reduces the amount available for the estate tax.

**Example:** A woman gives an annuity to her son by changing ownership to him. Her basis in the annuity is \$50,000; the fair market value of the annuity is \$200,000. In the year of the transfer, the gift tax annual exclusion amount is \$14,000; the applicable exemption amount for gifts is \$5M. This transaction means a taxable gift of \$186,000 has been made to the son (\$200,000 annuity less \$14,000 annual exclusion) and must be reported on IRS Form 709. Assuming she’s made no other taxable gifts in her life, she has \$4,814,000 of exclusion amount left. In this example, there is also an income tax consequence – she must recognize the \$150,000 gain as ordinary income from the transfer of the annuity. If she is under age 59½, the gain will be subject to a 10% penalty unless an exception applies.

## How the Generation Skipping Tax Works

The generation skipping transfer tax applies to transactions when assets are passed in a way that “skip” a generation.

- The generation skipping transfer tax *may* be levied on a transaction that is also taxes as an estate bequest or gift.
- The GST tax was designed to “catch” a portion of the taxes that would have been paid if the asset had been passed one generation at a time, rather than skipping levels and reducing transfers.
- Like the estate and gift taxes, the GST also has an exemption amount where transaction for less than the amount are not taxed. Unlike the gift and estate tax exemptions which are automatically applied to transfers as they occur, the donor or the executor determines how to apply the GST exemption.

**Example:** A man names five grandchildren as the beneficiaries of an irrevocable trust. Without notifying them or their parents (all living), he transfers a life insurance policy with a \$7M fair market value to the trust. In the year of this transaction, the applicable exclusion amount is \$5M for both gifts and the GST exemption is also. He has not used any of his applicable exclusion amount or his GST exemption. This gift exhausts his \$5M gift tax applicable exemption amount. He must file a gift tax return and pay gift tax on \$2M of the gift. In addition, the GST tax will apply to the gift. His \$5M GST exemption will be automatically allocated to the gift unless he elects otherwise when he files his gift tax return.

## Considerations

- Many states impose their own transfer taxes. These taxes are generally imposed at lower rates than the federal transfer tax rates. Any amounts paid to the state for transfer taxes are allowed as deductions in determining the federal tax.
- Transfer of life insurance policies to remove the excess of the death benefit over the value at the date of gift from the estate is common and often very tax efficient. Transfers of annuities are typically considerably less tax efficient.
- The basis used to determine gain varies depending on whether the property is received by gift or inheritance.
- Although gifts and transfers at death are part of a unified system, one may produce better results than the other, depending on the situation.



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## Essentially

The estate tax is often described as a voluntary tax. There are numerous ways to minimize transfer taxes if the transfer tax system is understood and the advice of competent professionals is sought before substantial gifts are made and as part of the estate planning process

