

THE TRANSFER TAX SYSTEM

Overview of the Transfer Tax System

In addition to federal and state income taxes, there are three types of “transfer” taxes: (1) the estate tax, which is imposed on transfers of property at death; (2) the gift tax, which is imposed on lifetime gifts; and (3) the generation-skipping transfer tax (the “GST tax”), which is imposed on certain transfers to or in trust for grandchildren and more remote descendants.

Federal Estate Tax

The federal estate tax is a one-time tax assessed at the time of death on the value of the decedent’s property owned at death. The estate tax is payable by the estate of the person who died and not by the recipient of the property. The gross estate of a decedent for federal estate tax purposes includes the fair market value at the date of death (or, if alternate valuation is selected, six months after the date of death) of all interests in property owned or held by the decedent over which the decedent retains control or has certain powers. The types of property included in the gross estate include, but are not limited to, real estate, cash, bank accounts, accounts receivable, certificates of deposit, stocks, bonds, life insurance proceeds where the decedent owned the policy or had “incidents of ownership,” vehicles, individual retirement accounts or other retirement benefits, all interests in a revocable trust created by the decedent, interests in a business, savings bonds, collectibles, jewelry, cemetery plots, income tax refunds and other personal property or items that the decedent owns at death or controls at death.

Under the current federal estate tax provisions, each person has an estate tax exemption in the amount of \$5,000,000, which allows a person to transfer such amount at death to anyone without incurring federal estate tax, provided the person has not made any lifetime taxable gifts that may be included in calculating the decedent’s gross estate. Under current law, the estate tax exclusion amount is scheduled to be reduced to \$1 million in 2013, the estate tax exemptions are as follows:

Calendar Year(s)	Estate Tax Exemption
2011-2012	\$5,000,000
2013	\$1,000,000

The maximum estate tax rate is currently 35%, but is set to return to 55% in 2013.

Gift Tax

The federal government imposes a gift tax on property transferred by gift. The gift tax is payable by the person making the gift (often called a “donor”). A gift can occur whether the transfer is made outright or in trust and whether the transfer is direct or indirect. The gift must be a completed gift, which means that the donor must relinquish all control over the property. If the donor does not relinquish control over the property, the transfer is not a completed gift, and, therefore, it is not taxable.

The gift tax is applied to the amount of gifts over the gift tax annual exclusion. The gift tax annual exclusion amount is currently \$13,000 (originally a \$10,000 annual exclusion, it is adjusted for inflation each year, rounded down to the nearest 1,000). Any individual can give \$13,000 to any number of individuals (often called “donees”) each year, or \$26,000 per donee if the gift is split between spouses (i.e., someone who is married, with the consent of his or her spouse, may give \$26,000 per donee each year, and one-half of the gift is deemed to have been made by the spouse). Annual exclusion gifts generally are not subject to GST tax.

In order for a gift to qualify for the gift tax annual exclusion, the gift must be a gift of a “present interest.” Accordingly, gifts in trust generally do not qualify for the gift tax annual exclusion. Withdrawal rights, however, such as those commonly used in irrevocable life insurance trusts, may qualify a trust interest as a present interest to the extent of the withdrawal right. (See, “Irrevocable Life Insurance Trusts” Article). Certain trusts for minors allowed under Section 2503(c) of the Internal Revenue Code and gifts to minors under various state custodianship laws also qualify as present interest gifts. (See, “Gifts to Minors” Article). Additionally, direct payments of tuition to an educational institution or of medical expenses to a health care provider are not treated as gifts. A donor may make unlimited amounts of such payments without any gift tax consequences.

For tax years 2011 and 2012, every individual has a \$5,000,000 gift tax exemption that shelters transfers during life aggregating such amount. Any gifts in excess of such amount will be subject to gift tax.

Generation-Skipping Transfer Tax

Before 1986, it was possible to avoid taxes at the children’s generation by transferring property outright or in trust to grandchildren. Individuals also could transfer property in trust for grandchildren and future generations and pay estate or gift taxes only at the time the trust was created. In 1986, however, the ability to pass property to one’s grandchildren and more remote descendants without an estate or gift tax at each generation was curtailed by the enactment of the generation-skipping transfer tax (“GST tax”). This new tax was designed to capture the tax that would have been generated by estate or gift taxes if property had passed from each generation to the following generation in uninterrupted sequence.

The GST tax is imposed on any transfer of property in excess of the GST exemption from a donor to individuals who are more than one generation younger than the donor, if the donor and the donee are related (*e.g.*, transfers to grandchildren, great-grandchildren, grand-nieces and -nephews, and so forth), and if they are not related, if the donee is 37½ years or more younger than the donor. Such donees are called “skip persons.” The GST tax applies whether the transfer to the skip person is an outright gift or bequest, a distribution to a skip person of income or principal from a trust, or a distribution to a skip person on the termination of a trust. The GST

tax is imposed on non-exempt transfers at a rate equal to the maximum estate tax rate, and it is assessed in addition to any gift tax or estate tax that may be imposed on the transfer.

Each individual currently may transfer \$5,000,000 free of the GST tax. The individual (or the individual's executor) may allocate this \$5,000,000 GST exemption to transfers made during life or at death.

An outright gift to a skip person that qualifies for the federal gift tax annual exclusion also will be exempt from GST tax. A gift in trust for a skip person, however, will not be exempt from GST tax unless the skip person is the sole beneficiary of the trust and the trust will be included in the skip person's gross estate for federal estate tax purposes if the skip person should die before the trust terminates.

Deductions from Estate and Gift Tax

Transfers during life or at death to a spouse or charity entitle a donor or a decedent's estate, as the case may be, to a deduction in calculating the amount of gift tax or estate tax due.

The Marital Deduction. The marital deduction is unlimited, which means that it eliminates any gift tax or estate tax on transfers between spouses. Although certain requirements must be met in order for the marital deduction to apply, in general, property transferred to a spouse qualifies for the marital deduction if it is:

- Given outright to the spouse (e.g., by a lifetime gift, pursuant to a decedent's will or trust agreement, property held in joint tenancy, by beneficiary designation, or by a disclaimer);
- Given to a trust over which the spouse has the unlimited right to withdraw the trust property or to appoint the property to anyone (including the spouse's estate or creditors) at the spouse's death; or
- Given to a qualified terminable interest property ("QTIP") trust. QTIP trusts provide income to the spouse, with the remainder of the trust property passing according to the trust's instructions. The spouse may, but need not, receive principal distributions from the QTIP trust during the spouse's lifetime, but the QTIP trust can distribute property only to the spouse during the spouse's lifetime. Any property remaining in the QTIP trust at the death of the surviving spouse will be included in the spouse's gross estate for federal estate tax purposes at death.

The Charitable Deduction. In addition to the marital deduction, a decedent's estate is entitled to an estate tax charitable deduction for property included in the decedent's gross estate that will be distributed to charity, and a donor is entitled to a gift tax charitable deduction for property transferred to charity during life. The charitable deduction is unlimited. A deductible charitable transfer can be outright or in trust. In either case, no private person may have an interest in the donated property unless the gift is in a certain form, such as a charitable remainder trust.

State Gift and Estate Tax Laws

State governments also may impose taxes on lifetime gifts and/or transfers at death. Most states do not impose any gift tax.

Currently, the State of California does not have an inheritance or an estate tax.

Federal Income Tax Considerations

As noted above, the gift tax and the estate tax are imposed on the donor and the decedent's estate, respectively. The gross income of the recipient does not include the value of property acquired by gift, bequest, devise or inheritance. Therefore, the receipt by a donee of a gift or by an estate beneficiary of a bequest or devise does not produce taxable income for such persons. This exclusion only applies to the property actually transferred, however, and does not apply to any income or appreciation after the property is received.

Under current law, when an individual receives an asset by lifetime gift, the donee's basis in the asset is the same as the donor's basis in the asset. This is known as the "carryover basis" rule. When an individual inherits an asset from a decedent, the individual's basis in the asset is adjusted to equal the fair market value of the asset on the date of the decedent's death. Because most assets increase in value over time, this basis rule is commonly referred to as the "step-up in basis" rule, although application of the rule can result in a "step-down in basis" as well. Under the Act, the step-up in basis rule will be eliminated in 2010 and replaced with a carryover basis rule.

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Please contact Albertson & Davidson, LLP at (951) 686-5296 for further information regarding the transfer tax system and any estate planning options.

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