

Overview of Federal Estate and Gift Taxes

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I. INTRODUCTION¹

Because the estate and gift tax rates go up to 48% (excluding any state death or gift taxes), estate planning is a necessity. Proper planning for the orderly transfer of assets will produce effective tax savings.

The federal estate and gift tax systems are unified for taxing transfers of property which take place both during lifetime and at death. The rates of taxation for gifts made during lifetime and for testamentary transfers are the same. A single progressive tax rate schedule is therefore applied to cumulative lifetime gifts and testamentary transfers. An additional tax is the generation-skipping transfer tax (GST) which precludes property from skipping over a generation without transfer taxes being imposed. The GST is scheduled to be repealed in 2010.

This outline will review the estate tax first, then the gift tax. It does not address the GST, except in passing, but planning for or around it is a critical part of estate planning. This outline will give an overview of what an estate is, what its components are, how it is valued, what deductions and credits are allowed, how the tax is calculated, and the various methods of how estate taxes can be paid. Lifetime gifts will be similarly reviewed.

There are significant opportunities for post-mortem estate planning, where options are available to both the surviving spouse and the legal representatives of the estate, but that, too, is beyond the scope of this outline, except in passing.

Because the United States imposes an estate tax on all assets located worldwide of both its citizens and its residents, international estate planning is very important. That topic, too, is only touched upon briefly in this outline.

In effect, the estate tax is imposed upon the privilege of transferring property at death (whether the beneficiaries are designated by the decedent or by the laws of intestate succession), and based upon the value of the entire estate left by the decedent (and by cumulative taxable gifts made by the decedent during lifetime), rather than on the shares received by the respective beneficiaries.

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Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), each taxpayer’s applicable exclusion amount against estate and gift tax gradually increases from \$1,500,000, in 2004 to \$3,500,000 in 2009. The estate tax is scheduled to be repealed in 2010. The following chart summarizes the estate and gift tax rates and applicable exclusion amounts for 2002 through 2010:

Calendar Year	Estate and GST tax deathtime transfer exemption	Highest estate and gift tax rate
2002	\$1,000,000	50%
2003	\$1,000,000	49%
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	44%
2009	\$3,500,000	43%
2010	Taxes repealed	Gift tax only = highest individual rate

The taxable estate (including any lifetime taxable gifts) must exceed the applicable exclusion amount before a tax liability is incurred. If federal estate tax applies, however, the lowest rate is 45% and rises to 48%. When examining the potential size of the estate, the combined assets of both spouses must be considered, and the death benefits value of all life insurance and retirement benefits must be included. This will often result in a much larger potential estate than clients initially anticipate.

II. AN OVERVIEW OF THE ESTATE TAX

- A. The estate tax is broadly inclusive. That is, estate taxes are imposed on the very property which will be used to pay the tax, and on nonprobate, as well as probate, property.
- B. All citizens and residents of the United States, and any persons owning property in the United States, are subject to federal estate tax. The estate itself is liable for the tax. The beneficiaries of the estate may have to pay the tax if the estate does not pay it when it is due. The rate of taxes depends upon the value of the taxable estate. Many states impose estate taxes as well. There are several exemptions available which permit property to pass free of estate taxes. The significant exemptions are the (1) applicable exclusion amount, currently in 2004 equivalent to \$1,500,000 in property; (2) the unlimited marital deduction which permits benefits left to a surviving spouse to be transferred free of taxes; and (3) property given to recognized charities.
- C. It is difficult to eliminate state estate taxes. The goal of the estate planner should be to minimize or reduce the estate taxes imposed on transfers from one generation to the next. Many opportunities to do so exist.

III. THE GROSS ESTATE

A. What Is Included in the Gross Estate?

1. All property in which one has an interest at the time of death is included in the gross estate. This includes: (1) one-half interest in community property; (2) joint interests; (3) annuities; (4) property subject to a general power of appointment; (5) life insurance proceeds; (6) life interest in property for which a QTIP or other marital deduction was previously elected; and (7) property gifted during lifetime (unless meeting special conditions). The gross estate does not include interests in property that terminate at the time of death, such as true life estates.
2. The gross estate includes the full value of all property of a U.S. citizen or resident no matter where the property is situated. If property is taxed by a foreign country, a credit for foreign death taxes may be available to reduce the U.S. federal estate tax.
3. Certain income is also included in the gross estate, such as the right to receive dividends, interest, rents, and compensation, and retirement benefits. Income accrued prior to death but not reportable on the final income tax return is known as “income in respect of a decedent” (IRD). There is a special income tax deduction for estate taxes attributable to the inclusion of IRD in the gross estate, but IRD, in effect, is taxed twice at death.

B. Community Property.

1. In the community property system (for example, the states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington), all property acquired by the spouses during their marriage is regarded as owned in equal shares by the spouses, and therefore each spouse has a vested interest in one-half of the shared property.
2. The one-half interest acquired while the spouses are domiciled in a community property state continues even though the taxpayer subsequently moves to a noncommunity property state. However, each spouse may also acquire other property separately by gift or inheritance. At the death of one spouse, therefore, only one-half of the community property and all of the separately acquired property is included in that taxpayer’s gross estate.

C. Joint Interests.

1. Included in the gross estate is the entire value of property held as joint tenants with a right of survivorship at death. The value of the interest in the property, however, will be reduced to the extent that the estate can show that the surviving joint tenant: (1) had an original ownership interest never transferred for full consideration to the decedent; or (2) made an original contribution to the cost of acquiring the property,

unless this contribution came from the decedent's funds.

2. If the joint tenants are spouses, unless one of the spouses is not a U.S. citizen, only one-half of the value of the asset is included in the deceased spouse's gross estate at death, regardless of who furnished the original consideration.

D. Retirement Benefits and Annuities.

1. The gross estate includes the value of retirement accounts or an annuity which still has residual value after death. (For example, one which is payable to a beneficiary.) This includes payments from qualified pension, stock bonus or profit sharing plans, tax-deferred annuities, individual retirement accounts (IRAs), and certain military retirement plans.
2. The amount included in the gross estate is the proportion of the annuity attributable to the decedent's contributions to the purchase price. Contributions made by an employer or former employer are deemed to be contributed by the decedent if made by reason of employment.

E. Powers of Appointment.

Any property over which the decedent had a general power of appointment at the time of death is included in the estate. A general power of appointment allows the appointment of property to oneself or to one's estate, one's creditors, or the creditor's of one's estate. A power of appointment is not general, and as such is not included in the estate, if it can be exercised only in favor of specific persons or a limited class of persons.

F. Proceeds of Life Insurance.

Generally, the proceeds of an insurance policy on the decedent's life, whether payable to the estate or to other beneficiaries, are included in the gross estate. This rule does not apply, however, if at the time of death the decedent retained no incidents of ownership in the insurance policy and the proceeds were not payable to the estate or used for the benefit of the estate. An example is life insurance owned by an irrevocable life insurance trust.

G. Life Interests for Which a QTIP Marital Deduction Was Previously Allowed.

A marital deduction is allowed for the value of all property in which a surviving spouse receives a lifetime "qualifying income interest." This property is known as "qualified terminable interest property" (QTIP) and is includable in the gross estate of the surviving spouse if the estate of the first spouse takes a marital deduction with respect to this property.

H. Certain Property Transferred During Decedent's Lifetime.

The gross estate includes: (1) transfers effective only on decedent's death; (2) transfers with a retained life estate (unless meeting special conditions); and (3) revocable transfers. These types of transfers, together with gifts of life

insurance and all gift taxes paid within three years of death, are included in the gross estate.

I. Gifts Made Within Three Years of Death.

Generally, the value of property transferred as a gift prior to death is not includable in the gross estate, but it may be subject to the gift tax. However, certain gifts within three years, such as a gift of life insurance, a transfer effective at death, a transfer with a retained life estate, or a revocable transfer, are included in the gross estate.

J. Transfers Effective at Death with Reversionary Interests.

The gross estate includes the entire value of property transferred as a gift if the donor retained a reversionary interest in the property (a right to receive the property back at some future date). This is so if the value of such right immediately before death is in excess of five percent of the value of the entire property. For example, the decedent creates a trust to pay income to his brother for his lifetime. Upon the brother's death, the brother's son is to receive the principal of the trust. If the son is not living at the time of the brother's death, the trust principal reverts back to the decedent. If there is a greater than five percent chance that the decedent will outlive his brother's son, the trust principal is included in the decedent's gross estate. In order to determine this potential "chance," the ages and health of all of the significant parties are evaluated actuarially under IRS tables.

K. Transfer with a Retained Life Estate.

The gross estate includes the value of all property, to the extent of the decedent's interest, which the decedent transferred at any time, by trust or otherwise (unless by a sale for full consideration), and in which the decedent has retained an interest for life, or for a term of years. These retained interests are the possession, enjoyment, or right to the income of the property, or the right to designate the persons who will possess or enjoy the property or the income from it. (There are special trusts that can create exceptions to this rule.)

Example: The decedent creates a trust to pay income to his descendants during his lifetime. In the trust, the decedent retains the power to determine from year to year which of his descendants will actually receive the income and in what proportions. This retained power causes the entire trust property to be included in the decedent's gross estate.

L. Revocable Transfers.

The gross estate includes the value of any interest in property transferred to another person for less than full and adequate consideration, if the decedent possesses at the time of death the power to alter, amend, revoke, or terminate the transfer in favor of anyone, such as the power to change a beneficiary.

M. Qualified State Tuition Programs.

The gross estate includes excess contributions properly allocable to periods after the death of the donor. § 529(c)(4)(C).

Example: In 2004, Tom contributed \$55,000 to the Ohio Tuition Trust for his grandchild John. Tom filed a gift tax return and elected to treat the contribution as qualifying for the \$11,000 annual exclusion over five years (2004-2008). If Tom dies in 2006, \$22,000 (the gifts for years 2007-2008) will be included in his gross estate.

N. Health Savings Accounts.

The gross estate includes an amount equal to the fair market value of the assets in such account as of the date of death. §223(f)(8)(B).

IV. HOW IS THE PROPERTY OF THE ESTATE VALUED?

A. Date of Death or Alternate Valuation Date.

The property included in the decedent's gross estate is valued as of the date of death, unless the personal representative elects a date six months after the date of death (the "alternate valuation date"). The alternate valuation date may be chosen only when it reduces both (1) the value of the gross estate; and (2) the estate tax liability. The alternate valuation applies to all the includable assets of the estate. The amount of the marital and charitable deductions, which depend on the value of property passing to a spouse or charity, must also be adjusted to the alternate value. The value of property that is sold between the date of death and the alternate valuation date is, for estate tax purposes, its sales price.

B. Estate Tax Savings versus Income Tax Savings.

There is usually a trade-off between estate and income tax savings when choosing the alternate valuation date. Because the estate tax values of estate assets become the inherited cost basis for income tax (capital gains) purposes, for the beneficiaries of the estate, the alternate valuation date ordinarily should be used only if the reduction in estate taxes exceeds the present value of the additional income taxes payable, because of the lower basis of the assets received by the beneficiaries as a result of using the lower alternate values. Therefore, the decision regarding the alternate valuation election depends upon several factors, including the estate tax rate, the income tax rates of the beneficiaries, and their investment goals.

C. Fair Market Value.

The value of assets includable in the estate is their fair market value on the valuation date. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. If the item is one generally sold on the market, the fair market value is the price at which the item or a comparable item would be sold.

Appraisals may be required.

A special use valuation election is available to those whose estates consist largely of a farm or other closely held business that allows the property to be valued at its farm or business use value rather than at its fair market value. §2032A.

D. Valuation and Beneficiary's Basis.

1. Once it is determined what property to include in the gross estate, then a value must be established. Section 2031 values the property at fair market value on the date of death; however, § 2032 allows an election to determine the value six months after the date of death if both the value of the estate and estate taxes have decreased since the date of death. When the alternative valuation date is made and the date of death is on the 31st of the month with no corresponding date in the six months following the date of death, the valuation date is the last day of the sixth month following death.
2. When the property is distributed before the alternative valuation date, it is valued on the date of distribution. Except where the decline in value is due to a mere lapse in time, as with annuities or royalties, the date-of-death value must be used. However, where the alternative date is elected, earnings and expenses occurring after the date of death are not included in the estate.
3. Section 2032A provides for valuing certain real property used in farming or in a trade or business at its current use value, rather than its highest and best use value.
4. Beneficiaries' basis in inherited property is its fair market value on the valuation date, except for property that constitutes income in respect of a decedent (IRD). In community property states it is important to note that the surviving spouse' half of community property receives a step up in basis in addition to the decedent' half. Property inherited is deemed to have a holding period in excess of six months, regardless of when the decedent acquired the property.

V. **DEDUCTIONS FROM THE GROSS ESTATE**

The I.R.C. authorizes the deductions available to an estate in arriving at the taxable estate. Specifically, §§ 2053 to 2057 describe the following different deductions.

A. Expenses.

Section 2053 allows for the deduction of funeral expenses, administration expenses, claims against the estate (debts of the decedent, tort, claims, *etc.*), and unpaid mortgages on property included in the gross estate. Expenses are determined on an accrual basis, but are restricted to "reasonable" expenses allowed under state law, and debts must be obligations of the decedent existing as of date of death, enforceable against the estate under state law. Examples of allowable claims include charitable pledges, accrued interest and taxes, expenses of last illness, and post-death alimony. Administration

expenses may be deducted on either the estate tax return or the estate's income tax return, but not both.

B. Losses.

Losses incurred during the settlement of an estate arising from fire, storms, thefts, or other casualties, to the extent such losses are not compensated for by insurance are deductible under § 2054. If the alternative valuation date is used, the loss is limited to losses occurring after the valuation date, since losses before the valuation date should be reflected in the valuation. The deduction is limited to losses occurring to property held by the estate and not yet distributed to the heirs. Losses occurring after distribution are deductible on the beneficiary's income tax return, Form 1040, subject to the casualty loss limitations.

C. Charitable Gifts.

Deductions for bequests, legacies, devises, or transfers for public, charitable, and religious use are permitted under § 2055. The deductions for estate tax purposes are similar to, but not exactly the same as for, income tax purposes.

D. Marital Gifts.

1. Unlimited marital deduction.

Section 2056 allows an unlimited deduction for qualifying property passing to a surviving spouse. However, wills executed before September 13, 1981, that provided for property passing to the surviving spouse, using the pre-1982 marital deduction formula, are still subject to the limited marital deduction law in effect in 1981. To qualify for the marital deduction, the decedent must be a citizen or resident of the United States who is survived by a U.S. citizen spouse who inherits property from the decedent. The property must not be nonqualifying terminal interest property and must be included in the decedent's gross estate but subject to the deduction.

2. Joint interests.

Property passing to the surviving spouse as a joint tenant by right of survivorship, through dower or courtesy interests, under powers of appointment, and by transfers made during life that are included in the gross estate, all qualify for the marital deduction. The deduction also applies to life insurance proceeds paid outright to the surviving spouse or to a trust which itself qualifies for the marital deduction.

3. Transfers to a spouse in trust.

A transfer of property to a trust under which all beneficial interests pass to the surviving spouse may also qualify for the marital deduction.

Caution: No marital deduction is allowed for property passing to a surviving spouse who is not a U.S. citizen unless the property passes in the special form of a qualified domestic trust (QDOT). EGTRRA included special rules for QDOTs for decedents dying before January 1, 2010. There will continue to be an estate tax imposed on any distribution from a QDOT made prior to January 1, 2021, that occurs before the date of the non-citizen surviving spouse's death. Additionally, there continues to be an estate tax imposed on the value of the property remaining in a QDOT on the date of the non-citizen surviving spouse's death if such surviving spouse dies before January 1, 2010. This topic is very important but is beyond the scope of this outline.

4. QTIP transfers.

Transfers of a life estate to a surviving spouse in the form of qualified terminable interest property (QTIP) is an exception to the terminable interest rule and qualifies for a marital deduction. The spouse must have a "qualifying income interest" for the property to be so designated. This means that he or she must be entitled to receive all the income from the property at least annually, and that no person can appoint the property during the spouse's lifetime to anyone other than the spouse. The transfer may be in the form of a life estate or a trust. The donor may retain or create powers over part or all of the QTIP corpus, but only if they are exercisable on or after the surviving spouse's death. Thus, the surviving spouse need not be given a general power of appointment. In order to qualify a transfer as QTIP, an election to take the marital deduction for a QTIP transfer must be made by the personal representative on the estate tax return, and it is irrevocable.

E. Qualified Family-Owned Business Deduction ("QFOBI Deduction").

Section 2057 allows owners of qualified family-owned businesses to receive an additional estate deduction allowing up to another \$300,000 (for the year 2003) to pass free of estate taxes. (This deduction is coordinated with the maximum applicable exclusion amount available so that the two together equal \$1,300,000.) The decedent (or family members) must meet a material participation test (five of the eight years preceding death) and other technical requirements, and the benefit is recaptured if the business is disposed of within 10 years after death.

Under EGTRRA, the QFOBI Deduction will be repealed for the estates of decedents dying after December 31, 2003. However, the recapture tax (if property ceases to qualify for the QFOBI Deduction) will be retained after the repeal of the QFOBI deduction in 2004 and the estate tax generally in 2010. This provision is retained so that estates that claimed the benefit of the deduction before the repeal will be subject to recapture if a disqualifying event occurs following repeal.

F. International Estate Planning.

1. All property worldwide is taxed.

Federal estate taxes are imposed on all property owned by U.S. citizens worldwide and by residents whether they are citizens or not. The United States does have estate tax treaties with various countries, which in some instances provide for full credits for estate taxes paid to another country. If no treaty exists, the foreign country could tax its citizen, and if that citizen resided here, the United States could tax the same assets as well. A foreign citizen who may not reside here is subject to U.S. estate tax if he or she owns property here.

2. Property is considered “located” in the United States if it is:

- a. Real property located in the United States;
- b. Tangible personal property located in the United States. This includes clothing, jewelry, automobiles, furniture, or currency;
- c. A debt obligation of: a citizen or resident of the United States, a domestic partnership or corporation, any estate or trust (but not a foreign estate or trust), the United States, a state or a political subdivision of a state, or the District of Columbia;
- d. Shares of stock issued by domestic corporations; and
- e. Other intangible property.

G. Property Not Located in the United States.

1. Notwithstanding the above rules, property of a nonresident and noncitizen decedent is not considered located in the United States if it is:

- a. A deposit with a U.S. bank, if the deposit was not connected with a U.S. trade or business and was paid or credited to the decedent’s account;
- b. Stock issued by a corporation that is not a domestic corporation, even if the certificate is physically located in the United States; or
- c. An amount receivable as insurance on the decedent’s life.

As an example, a foreign citizen residing outside of the United States, owning shares of stock of a domestic corporation would be subject to federal estate tax on those shares. The estate tax might be avoided by the creation of an offshore entity to own the stock.

2. There are certain government securities that are exempt from federal estate tax, such as Treasury bonds which mature longer than six months from inception. The rationale for making them estate tax free is to encourage their purchase by foreign nationals.

3. There are certain estate planners who advocate expatriation to a country that does not impose estate taxes. (Canada, Ireland, and the Bahamas do not impose estate taxes). However, U.S. law imposes a ten-year rule. This rule provides that if the decedent dies within 10 years of changing citizenship, all property owned through foreign corporations, directly or indirectly, is added back into the estate. This means that if one expatriates, one must liquidate and remove all of your property from the United States.

H. Disclaimers.

If the surviving spouse disclaims a bequest, it is treated as if it did not pass to him or her and therefore does not qualify for the marital deduction. Conversely, an interest disclaimed by a beneficiary which passes to the surviving spouse does qualify for the marital deduction. A disclaimer is not the same as acceptance of the property and subsequent alienation of it. A formal “qualified disclaimer” must be executed in writing and delivered to the personal representative of the estate within nine months after the transfer or date of death, or in the case of a minor by the age of majority.

I. Basis of Property Acquired from a Decedent.

1. Basis of assets received from a decedent prior to 2010 is the fair market value of the asset as of the date of the decedent’s death (or the alternate valuation date).
2. Basis of assets received from a decedent after 2009 is the *lesser* of decedent’s carryover basis or the fair market value of the asset as of the date of decedent’s death (or the alternate valuation date).
3. For deaths after 2009, the executor of a decedent’s estate has the authority to increase the basis of assets passing from the decedent from their carryover value to a stepped-up date of death value. The executor can generally step up the basis of assets totaling \$1,300,000. Basis of appreciated property transferred to a surviving spouse can be increased by an additional \$3,000,000. Nonresidents who are not U.S. citizens can increase basis up to \$60,000. These amounts are indexed for inflation.
4. Property not eligible for the basis increase include:
 - a. Property acquired by the decedent by gift (other than from the spouse) during the three-year period prior to death;
 - b. Property that constitutes a right to receive IRD;
 - c. Stock or securities of a foreign personal holding company;
 - d. Stock of an international sales corporation (or former DISC);
 - e. Stock of a foreign investment company; and
 - f. Stock of a passive foreign investment company (with limited exceptions).

VI. OVERVIEW OF CREDITS ALLOWED AGAINST THE ESTATE TAX

A. Applicable Exclusion Amount.

Each estate is allowed an “applicable exclusion amount” against the estate tax. This credit shields a total transfer of \$1,500,000 for decedents in 2004, going up to \$3,500,000 in 2009. The amount of the credit that is not used will be lost; it cannot be used later by the second spouse to die, although the second spouse also has his or her separate credit.

Especially for a married couple, the way for which the exemption is planned can have a positive result of estate tax savings. This exemption can avoid tax by creating a trust in the estate of the first spouse to die in the amount of the exemption, for the benefit of the surviving spouse who may receive all income therefrom and the principal, if necessary, upon ascertainable, defined conditions. Upon the death of the second spouse, the property in the trust (remainder) will pass to the next generations, free of estate tax in both parents’ estates. The second parent has an additional credit. If both spouses create such a plan, then upon the death of the survivor of them, they can effectively pass \$3,000,000 to their heirs, estate tax free (\$7,000,000 in 2009).

B. Credit for State Death Taxes.

A federal credit is allowed against the federal estate tax for any inheritance, estate, legacy, or succession tax paid to any state or to the District of Columbia. Many states impose a “credit estate tax.” This tax is equal to the maximum federal credit for the state death taxes computed in calculating the federal estate tax. This type of estate tax is commonly referred to as a “sponge tax” or “pickup tax.” This means that the state does not have an estate tax per se, but simply receives the amount of the credit calculated in a federal taxable estate as its state death tax. The total tax paid by the estate is the same as if there were no state tax.

For 2002, the state death tax credit allowable under current law was reduced by 25% (from 2001 amounts). In 2003, it is reduced 50% (from 2001 amounts). In 2004, it is reduced by 75% (from 2001 amounts). In 2005, state death tax credit is repealed, but a deduction for state death taxes actually paid is instituted.

C. Credit for Gift Tax.

A credit against the estate tax is allowed for certain gift taxes paid on gifts, for any portion of such a gift that is later included in a decedent’s gross estate.

D. Credit for Tax on Prior Transfers.

A credit against the estate tax is allowed for transfers previously taxed (TPT tax) on the transfer of property to the present decedent from a person who died within 10 years before, or within two years after the present decedent’s death. The original transferred property need not be identified in the present decedent’s estate nor be in existence at the time of his or her death. It suffices that the prior transfer of property was subject to federal estate tax in the prior person’s estate and that the prior person died within the prescribed time. The credit is reduced by a schedule if the prior person died before the present

decedent by more than two but less than 10 years.

E. Credit for Foreign Death Taxes.

A credit against the federal estate tax is allowed for any estate, inheritance, legacy, or succession taxes actually paid to any foreign country on property located in that country which is included in the decedent's gross estate. The credit cannot exceed the federal estate tax attributable to such property. The credit must be claimed within four years after the filing of the estate tax return.

VII. CALCULATION OF THE ESTATE TAX

A. The Calculation Process Simplified.

The allowable deductions are subtracted from the gross estate to arrive at the taxable estate, which is then added to post-1976 adjusted taxable lifetime gifts to arrive at the unified transfer tax base. A tentative tax is calculated on the unified transfer tax base pursuant to § 2001 (the unified transfer tax rate). From the tentative tax is subtracted the deemed gift taxes paid on post-1976 gifts (applying the unified transfer tax rates in effect at the date of death to the total post-1976 taxable gifts), arriving at the gross estate tax from which the allowable unified transfer tax credit is subtracted. The calculation for the total process including the determination of the tax actually due is shown below.

A brief review of the available tax credits is as follows.

1. Applicable exclusion amount.

EGTRRA increased the applicable exclusion amount as follows:

	Amount
2002	\$1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000
2010	repealed

2. State death tax credit.

Section 2011 allows a credit for taxes imposed by the states and actually paid. For 2003, the maximum credit for an adjusted taxable estate over \$10,040,000 is \$1,082,800 plus 16% of the excess over \$10,040,000 multiplied by 50%. For 2004, the maximum credit for an adjusted taxable estate over \$10,040,000 is \$270,550 plus 4% of the excess over \$10,040,000.

3. Gift tax credit.

Section 2012 allows a credit for gift taxes paid on gifts made prior to 1977, if the property subject to the tax was included in the estate. The credit for pre-1977 gifts included in the estate is the actual tax paid.

4. Credit for prior estate taxes.

Section 2013 provides a credit for prior taxes on property inherited by the decedent within ten years before and two years after his death. The closer the date on which the property was received by the decedent to the date of his death, the greater the credit. The actual property does not have to be part of the estate to qualify for the credit.

5. Foreign death taxes.

Section 2014 allows a credit for any estate, legacy, or succession taxes actually paid to a foreign country for property located in that country that is included in the decedent's gross estate.

6. Credit on remainder interest.

Section 2015 provides for credit for death taxes on a remainder or reversionary interest paid to a state or foreign government for which the estate tax has been deferred.

7. Recapture of credits.

Section 2016 requires a recapture when an estate receives a refund of taxes claimed as a credit.

B. Chart of estate tax calculation for 2004.

Gross estate (§§ 2033 to 2046)		\$xxx,xxx
Less:		
1. § 2053 expenses, indebtedness, and taxes	\$xxx,xxx	
2. § 2054 losses	xxx,xxx	
3. § 2055 transfers for public, charitable and religious uses	xxx,xxx	
4. § 2056 bequest to surviving spouse	xxx,xxx	
Taxable estate		\$xxx,xxx
Plus:		<u>xxx,xxx</u>
Post-1976 taxable gifts (§ 2001(b))		
Total taxable transfers (§ 2051)		<u>\$xxx,xxx</u>
Tentative tax on total taxable transfers		\$xxx,xxx
Less:		(xxx,xxx)

Deemed gift taxes paid on post-1976 gifts	
Allowable applicable exclusion amount (§ 2010)	(xxx,xxx)
Credit for state death taxes (§ 2011)	(xxx,xxx)
Credit for federal gift taxes on pre-1977 gifts (§ 2012)	(xxx,xxx)
Credit for foreign death taxes (§ 2014)	(xxx,xxx)
Credit on prior transfers (§ 2013)	<u>(xxx,xxx)</u>
Net estate tax	\$xxx,xxx
Less:	
Prior payments	(xxx,xxx)
U.S. treasury bonds (flower bonds) redemption to pay estate tax	<u>(xxx,xxx)</u>
Balance tax due	<u>\$xxx,xxx</u>

C. Summary of Estate Tax Return Schedules.

Form 706 is the federal estate tax return form required to be filed by all U.S. citizens and residents whose estate tax base exceeds the equivalent taxable transfer for the applicable exclusion amount in the year of death (\$1,500,000 in 2004).

Form 706 has numerous schedules, as outlined below, many of which are misleading in their descriptive titles. The following is a brief summary of the Form 706 schedules and the information required on each. The value of each property listed on a schedule must be disclosed, and where the alternate valuation date is elected, both the date of death value and the alternate valuation must be disclosed.

1. Schedule A.

Schedule A has one of the more deceptive titles, real property. Listed on Schedule A is all real estate and contracts to purchase real estate that the decedent owned at the date of death. However, if the property was held in a business, sole proprietorship, or partnership, the property is reported on Schedule F. Property held as joint tenants or as tenants in the entirety is reported on Schedule E. Property interests, including mortgaged property, should be valued at fair market value (mortgages are listed on Schedule K) unless the mortgage is nonrecourse, in which case the property should be valued net of the nonrecourse mortgage. In addition to the value of the property, uncollected or accrued rents through the date of death are also reported on Schedule A. Any appraisals obtained in arriving at the value of the property must be attached.

2. Schedule B.

Schedule B requires the value of all stocks and bonds to be reported, foreign or domestic, publicly traded or closely-held, and state and local governmental. State and local bonds are subject to the gift and estate tax even though they are exempt from income tax. Jointly owned securities are reported on Schedule E, and trustee securities are reported on Schedule G. Information required on stocks includes the number of shares owned; type of stock; par value; price per share; exact name of the issuing corporation; principal exchange if listed, or if not listed, the post office address of the corporation's principal office; the state and date of incorporation; and CUSIP number, if available. Information required on bonds includes quantity; denomination; name of issuer; CUSIP number; type of bond; maturity date; interest rate; interest due date; exchange listed; and if not listed, the principal office address of the issuer.

3. Schedule C.

Schedule C requires cash, mortgages, and notes receivables to be reported. However, the value of silver or gold coins must be reported at their fair market value, not face value. Information required on mortgages and notes receivable includes face value, unpaid balance, date of mortgage and maturity, name of the maker, property mortgaged, and the interest payment date and rate of interest.

4. Schedule D.

Schedule D requires a complete listing of all life insurance on the decedent's life, even if it is not included in the gross estate. Form 712, which is completed by and acquired from the life insurance company that issued each policy, must be filed for each policy. For any policy not included in the gross estate, an explanation must be attached of why it was omitted. Life insurance policies owned by the decedent on the lives of others are reported on Schedule F.

5. Schedule E.

Schedule E is divided into two sections. Property jointly owned by husband and wife is reported on part one, and all other jointly owned property is reported on part two.

6. Schedule F.

Schedule F is where miscellaneous property is reported. Included in this schedule are tax refunds, household furniture, debts owed to the decedent other than notes and mortgages, leaseholds, publishing royalties, claims for refunds, and other interests not reported elsewhere.

7. Schedule G.

Schedule G requires the reporting of gift taxes paid within three years of death, transfers within three years of death, or life insurance policies and property in which the decedent held a retained life estate, reversionary interest, or revocable powers. In addition to the above, Schedule G requires all transfers (other than outright transfers not in trust and bona fide sales) made by a decedent at any time during his or her life must be reported on the Schedule regardless of whether the transfers are subject to tax.

8. Schedule H.

Schedule H requires any power of appointment to be reported and a certified or verified copy of the instrument creating the power of appointment. In addition, copies of any instruments where the power was exercised or released should be attached. The copies must be filed even if the power was a special or limited power of appointment.

9. Schedule I.

Schedule I requires the reporting of annuities, including the name and address of the grantor of the annuity. If the annuity is from a qualified retirement plan, the decedent's contribution ratio must be stated.

10. Schedule J.

Schedule J is for funeral and administration expenses. The expenses must be reasonable, allowed under local law, and have been or will be paid.

11. Schedule K.

Schedule K is divided into two parts. The debts of the decedent are reported on part one. This includes unpaid debts, expenses of last illness, accrued taxes, and unsecured notes. Part two lists mortgages and liens for which the decedent was liable. To qualify as a deduction, the debts must have been the obligation of the decedent that existed at the time of his or her death and that are enforceable against the estate.

12. Schedule L.

Schedule L is to report casualty losses, to the extent not covered by insurance, and expenses incurred in administering property not subject to claims but included in the estate.

13. Schedule M.

Schedule M is used to list all property passing to the surviving spouse that is eligible for the marital deduction. Property that is qualified terminal interest property (QTIP) and for which an election has been made to deduct the value of the QTIP property, must be grouped together and marked to indicate it is QTIP property. To make the election for QTIP property, you list the QTIP property on Schedule M

and deduct its value. You are presumed to make the QTIP election if you list property and deduct its value on Schedule M. The election is irrevocable.

14. Schedule O.

Schedule O is for reporting charitable, public, and other similar gifts and bequests. Attached to Schedule O should be: a certified copy of the order admitting the will to probate, a copy of the will, and a certified or verified copy of any other written instrument by which the property was transferred to the qualified charitable organization.

15. Schedule P.

Schedule P and Form 706CE should be completed to claim credit for foreign death taxes.

16. Schedule Q.

Schedule Q is used to determine the amount of credit for tax on prior transfers.

Elections of the executor are made on page two of Form 706 by checking either the “yes” or the “no” column. This may be deceptively simple, in that the return requires additional information that is not requested on page two, such as with the special use valuation.

17. Schedule R.

Schedule R should be completed to document the generation skipping transfers and to determine the tax (if any) on such transfers. If a tax is due, payment must be submitted with Schedule R-1 (payment voucher).

18. Schedule T.

Schedule T should be completed to claim a Qualified Family Owned Business Interest Deduction. This schedule contains an agreement which must be signed by all qualified heirs. The qualified heirs must consent to personal liability for the recapture tax if a disqualifying event occurs.

19. Schedule U.

Schedule U should be completed if there is a qualified conservation easement exclusion. EGTRRA repealed the restriction that the property must be located within 25 miles of a metropolitan area, national park or wilderness area or 10 miles of an Urban National Forest. Thus, any qualifying conservation easement is available for any qualifying real property that is located in the U.S. or any possession of the U.S.

If an estate claims this deduction, then the recapture tax provisions will be retained after the repeal of the estate tax in 2010. This provision is

retained so that estates that claimed the benefit of the deduction before the repeal will be subject to recapture if a disqualifying event occurs following repeal.

VIII. METHODS OF PAYING ESTATE TAX

- A. The largest burden that is usually placed on the estate is paying the federal estate taxes, ordinarily due within nine months from the date of death. The rates begin at 45% on property valued in excess of the applicable exclusion amount (\$1,500,000 in 2004). If the estate is not liquid, it could encounter financial problems in meeting these obligations. This could erode or reduce the value of the potential inheritances of the beneficiaries. With proper planning, married couples can avoid and postpone all estate taxes until the second of them dies, if that is appropriate.
- B. If the state of domicile imposes a death tax, this will have to be paid as well and usually within the same time deadline. Some states do not have the same estate tax structure as the federal government. This is often found in the area of the unlimited marital deduction. In such an event, the state may impose a state inheritance tax even though there may be no federal estate tax. Ohio has an unlimited marital deduction.
- C. A sound estate plan must not only include strategies for reducing the amount of estate tax ultimately payable by the beneficiaries but should also include techniques for providing for the payment of the tax that will be due.

Generally, funds to pay the estate tax can come from:

1. The maintenance of liquid investments by the decedent.
2. The sale of assets in the estate to raise the cash necessary to pay the tax. This may not be advantageous because of the possibility that a forced sale may generate lower prices. If there is an interest in a closely held business, a buy-sell agreement could ease a liquidity problem. In such a case, usually the business or the co-owners would purchase the interest. In many instances, the purchase from the estate is funded with life insurance owned by the surviving owners or by the company on the life of the deceased owner.
3. Life insurance, besides providing liquidity for the payment of estate taxes, can also be a method of reducing estate tax, because it can be kept out of the taxable estate through an irrevocable life insurance trust. One of its advantages is that the receipt of the death benefits from a life insurance policy comes about at approximately the same time that the obligations of the estate owner accrues.
4. Borrowing, including borrowing from the federal government under § 6166 of the Internal Revenue Code: Borrowing to pay estate tax is an alternative that may be available to create liquidity to pay for transfer costs. It may make economic sense if the after-tax cost of the loan is less than the return after tax on the funds. A problem that occurs sometimes with this approach is the ability of furnishing proper collateral satisfactory to the lender in order to obtain the needed

financing. Normally, estate taxes are due within nine months of death. However, if a closely-held business interest (EGTRRA increased the number of permitted partners/shareholders from 15 to 45) is included in the gross estate and if its value exceeds 35% of the adjusted gross estate, the estate may qualify for a deferral of tax payments under § 6166. Under this arrangement, only interest on the tax due is paid until four years after the normal due date for estate taxes on the value of the business. The estate tax related to the closely-held business interest can be paid in ten equal annual installments. As such, a portion of the estate tax is deferred for as long as 14 years from its original due date. Interest is charged for the deferred payments but only at the rate of two percent (after 1997) on the estate tax on the first \$1,140,000 (2004) [\$1,120,000 - the 2003 Federal estate tax return amount] of the closely-held interest.

Beginning in 2010, when the estate tax is repealed, § 6166 will be retained so that estates that entered into installment arrangements before repeal will continue to make payments past the repeal date. Additionally, the requirement to pay unpaid tax upon notice and demand if 50% or more of the value of the business is disposed of will be retained after repeal.

5. Section 303 redemption.

If the value of a closely held corporation is included in the gross estate and if the value exceeds 30% to 50% of the adjusted gross estate, the corporation may buy from the estate its shares of stock. The distribution from the corporation cannot exceed the amount of the estate taxes and the funeral and administrative expenses. If the redemption qualifies under the appropriate section, there is no negative income tax to the shareholders (dividend) resulting from the distribution. There are time requirements during which a § 303 redemption can occur. Distributions by a corporation in redemption of its shares of stock must take place within three years and ninety days after the filing of the estate tax return to qualify under § 303. If the estate has a dispute with the Internal Revenue Service in the Tax Court of the United States, the redemption must be completed within 60 days following the date on which the decision becomes final. Furthermore, if an extension of time is elected under § 6166, the redemption must be completed during the time determined for the payments of the installments.

IX. ESTATE PLANNING AFTER DEATH (POST-MORTEM PLANNING)

One's estate planning can be continued after death. Sometimes, this is planned for as part of good advance planning. Sometimes, it is a late, last-ditch effort to minimize taxes. Although an in-depth review is beyond this outline, here is a very brief summary of the main techniques:

- A. The estate can select a fiscal, rather than a calendar, year for income tax purposes. The benefits to this are twofold. (1) Income taxes on the income of the estate can be delayed; and (2) The income distributions received from the estate by a beneficiary will be included in that person's income tax return for

the following year (as opposed to the year of receipt by the estate).

- B. An estate can choose to deduct most of the expenses it incurs during the administration of the estate on either its income or estate tax returns (but not both).
- C. In order for the beneficiaries to get the benefit of certain losses and deductions of the estate in excess of the income for the final year, this should be paid in the year of termination.
- D. If a noncitizen spouse receives a bequest that is not in the appropriate form of a qualified domestic trust (QDOT), he or she can create such a trust and contribute the inheritance to it, thus preserving the marital deduction and the deferral of the estate taxes until his or her demise. The complex rules for QDOTs are beyond the scope of this outline.
- E. Disclaimers can be filed in order either to increase or decrease the marital or nonmarital share.
- F. If a surviving spouse is entitled to the distribution of qualified retirement plan benefits, he or she can elect to roll the distribution over and defer the income and the income tax over more years in the future.
- G. QTIP and QDOT treatment can be elected. If a spouse becomes a U.S. citizen before the estate tax return is filed, the QDOT trust will not be necessary.
- H. There are certain income tax elections that a surviving spouse must consider, such as:
 - 1. Not claiming any commissions (compensation) as an executor or personal representative;
 - 2. Making a roll-over of a lump sum retirement plan distribution; and
 - 3. Electing to file a joint final income tax return for federal and state purposes with the deceased spouse.
- I. In connection with generation-skipping trusts that are subject to Generation Skipping Tax (GST), distributions to a grandchild for medical expenses or to pay tuition (but not room and board) will not be subject to this type of tax.
- J. An election has to be made to step-up the basis of an interest bequeathed in a partnership.
- K. A beneficiary who might inherit property subject to GST tax could renounce an amount over the exemption level, \$1,120,000 (2003), \$1,500,00 (2004), to avoid GST tax.
- L. An election can be made to report interest on government savings bonds on the final income tax return of the deceased person.

X. LIFETIME GIFTS AND THE GIFT TAX

A. Introduction.

Because it is a unified transfer tax system, the federal tax rate on gifts is the same as the estate tax rate on property transferred at death. However, beginning in 2004, the applicable credit amount for gift tax continues to shelter only \$1,000,000. §2505(a)(1). The federal estate and gift tax systems are “unified,” so that, for example, one can make taxable gifts totaling \$1,000,000 (the applicable credit limit) while one is alive, and still be able to transfer \$500,000 of property at death in 2004 free of federal estate and gift taxes, because the total credit for gift tax purposes (\$1,000,000) was not exceeded and the total estate tax credit (\$1,500,000) was not exceeded. Gift taxes are not actually paid until the credit is used up (that is, one has \$1,000,000 of nontaxable gifts).

B. Definition of Gift.

A gift is a transfer of property without adequate and full consideration in money or money’s worth. To be considered a gift, the transfer is complete when it is alienated by the person who makes the gift and that person retains no power to change the disposition of the property.

C. Exclusions.

1. All gifts made in each calendar year are taxable, less the allowable exclusions and exemptions. These exclusions are: (i) the annual exclusion; and (ii) amounts paid on behalf of another person for certain educational expenses and for certain medical care.
2. The annual exclusion presently permits each person to exclude up to \$11,000 in gifts to each separate recipient each year, or \$22,000 if a husband and wife elect to join and split the gift from one of them. Generally, if a gift is split, a lower gift tax bracket is applicable to the total taxable gift. In addition to the annual exclusion, the applicable exclusion amount of each spouse applies to a split gift. If the gift is made in trust, each donor is entitled to the annual exclusion for each trust beneficiary. The Taxpayer Relief Act of 1997 has indexed the \$10,000 annual exclusion for inflation (in \$1,000 increments).
3. A gift of a future interest does not qualify for the annual exclusion. Any gift of an immediate interest in trust income is a gift of a present interest. If, however, the power to divert the trust income to other beneficiaries, or to accumulate or distribute the income, is at the trustee’s discretion, the gift is one of a future interest. Giving the beneficiary of a trust a so-called “*Crummey* power,” *i.e.*, the right to withdraw property from the trust when it is contributed to the trust, is considered a general power of appointment, and thus this gives a beneficiary a present interest in the trust. A contribution to a trust containing this provision would then qualify the gift for the annual gift tax exclusion. The rules governing *Crummey* powers are complex and beyond this outline.

Gifts to minors will also qualify for the annual exclusion, provided:

- a. The custodian may expend principal and income for the benefit of the minor prior to the minor reaching age 21;
- b. The unexpended principal and income must pass to the minor no later than age 21; and
- c. If the minor dies before age 21, the property is included in the minor's estate.

The exclusion may still be claimed if minors attain majority at age 18 under state law. Gifts to minors made pursuant to the Uniform Transfers to Minors Act (as in Ohio) or similar laws in other states will qualify for the annual exclusion as well.

4. An unlimited gift tax exclusion is allowed for tuition payments made directly to educational organizations and for unreimbursed medical cost payments made directly to health care providers for medical services, where these payments are made on behalf of another person. These exclusions are allowed in unlimited amounts in addition to the annual exclusion. (This is an especially attractive gifting opportunity for some grandparents.)

D. Charitable and Marital Deductions.

1. The gift tax charitable and marital deductions have the same basic requirements as their estate tax counterparts. The gift tax charitable deduction is also unlimited and available for gifts to the same recipients as would qualify as a bequest for the estate tax deduction. The same restrictions apply to gifts of property to charity where some of the interests in the property are noncharitable. These gifts must take one of a number of prescribed forms such as outright gifts or gifts to a charitable remainder annuity trust or unitrust.
2. There is an unlimited marital deduction for gifts made between spouses. In other words, one spouse may transfer unlimited amounts of assets to the other spouse without worrying about gift tax liability as long as the transfer meets the requirements of the Internal Revenue Code for deduction; *i.e.*, an outright gift or, if in trust, in the form of a QTIP trust or an estate trust in which the recipient beneficiary spouse is given the right to direct the disposition of the principal upon his or her death. A gift tax return need not be filed if a donor's gift qualifies for the marital deduction. *Caution:* A QDOT is necessary if the spouse is not a U.S. citizen.

E. Disclaimers.

1. A person may refuse to accept a lifetime gift by executing a qualified disclaimer, thereby causing the interest in the gift to transfer to another person. That transfer will not be considered as a gift if the formalities for a qualified disclaimer are followed. A qualified disclaimer must meet these requirements:
 - a. The disclaimer must be in writing; it must describe the interest disclaimed; and it must be signed by the disclaimant or his or

her legal representative;

- b. The disclaimer must be received by the maker of the gift within nine months of the creation of the property interest or within nine months of the date the recipient of the gift turns 21; and
- c. The disclaimant must not have accepted the interest or any of its benefits (such income off of the gifted property).

F. Computation of Gift Tax.

The rate of gift tax is determined by the total amount of all gifts made during the calendar year in question and in all the preceding years since June 6, 1932. The federal rates range from 41% to 48%. Ohio has no gift tax, but some states do.

The donor of the gift is responsible for paying the gift tax. If he or she dies before doing so, the executor or administrator of the estate must pay it out of the estate, or if there is no such person, the beneficiaries are liable.

G. Using Both Spouses' Applicable Exclusion Amounts.

Gifts made between spouses during lifetime may produce estate tax savings if it enables the estate of the first spouse to die to more fully use the applicable exclusion amount. This is particularly so if the estate of donee spouse would otherwise be less than the amount protected by the credit. The credit protects \$1,500,000 in 2004. Interspousal transfers may enable the estates of both spouses to take full advantage of the applicable exclusion amount. Such transfers would not be taxable as they are covered by the unlimited gift tax marital deduction. By utilizing the applicable exclusion amount in the combined estates of both spouses, up to \$3,000,000 can be transferred (\$7,000,000 by 2009), to others, free of the federal estate tax.

There may be some risks and disadvantages in interspousal gifts. The spouse who has received the gift might squander it. Divorce is sometimes a possibility. If the donor spouse dies first, the spouse's cost basis in the gifted property will continue to be the original basis, rather than the step-up basis at the donor's death. Some risk can be reduced by making a QTIP gift in trust with the children receiving the remainder after the death of the donee spouse, or by purchasing life insurance on the life of the spouse with the children designated as both the beneficiaries and the owners of the policy.

H. QTIP Gifts to Spouse.

- 1. With certain exceptions, if one gives one's spouse a gift of anything other than an outright gift, the value of the gift will not qualify for the marital deduction. The one exception to this rule allows the donor spouse to control who will receive the property when the donee spouse's interest terminates at death, and permits a marital deduction for the property which is a gift of qualified terminable interest property (QTIP). QTIP is property transferred to a trust in which the donee spouse has a qualifying income interest for life and with respect to which the donor makes an election on a gift tax return that the property

in trust be treated as QTIP. A qualifying income interest for life must give the spouse the right to all income from the property for life, payable at least annually, and prohibits distributions of the property held in the trust to anyone other than the spouse during his or her lifetime. A QTIP gift to a spouse has the same advantage as any other spousal gift, in that it may augment the spouse's estate so as to take more advantage of the spouse's applicable exclusion amount, while taking the property out of the donor's estate.

2. A QTIP election is not always beneficial. It may be advantageous not to elect marital deduction treatment for lifetime gifts of a terminable interest. This alternative involves the donor's use of his or her applicable exclusion amount to shelter the gift to the spouse and ultimately to permit the transfer of any appreciation in the property tax free to the donor's children or grandchildren.

I. Gifts Made by an Attorney-in-Fact.

If one becomes incapacitated, one's ability to continue gift giving would be terminated unless a properly prepared durable power of attorney is in effect. This document may specifically authorize the attorney-in-fact to make gifts on the principal/donor's behalf. Without the proper specific language, the Internal Revenue Service would not recognize any such gifts and would include any gifts made by the attorney-in-fact after the occurrence of the disability, in the donor's gross estate at death.

J. A Gift by a Nonresident Citizen.

If one is neither a citizen nor a resident of the United States, the federal gift tax only applies to a transfer of property that is situated in the United States.

K. A Gift to a Noncitizen Spouse.

A gift to a noncitizen spouse does not qualify for the marital deduction (regardless of the donor's citizenship). However, the first \$112,000 (2003) of gifts made to a noncitizen spouse during the year will not be taxed. If gifts are made in excess of this amount, no marital deduction will apply to reduce the gift and, as such, are subject to gift tax. However, this \$112,000 annual exclusion for transfers by gift to a noncitizen spouse is allowed only for transfers that would qualify for the marital deduction if the recipient spouse is a U.S. citizen. Thus, a gift in trust does not qualify for the annual exclusion unless it is within one of the exceptions (QTIP) to the terminable interest rule. The \$114,000 annual exclusion for gifts to a noncitizen spouse is available regardless of whether the donor is a citizen, resident alien, or a nonresident alien. On the other hand, a gift to a citizen spouse will qualify for a gift tax marital deduction regardless of the citizenship of the spouse making the gift.

L. Deathbed Gifts.

Generally, gifts made within three years before death are not includable in the gross estate for estate tax purposes. The only gifts that would be includable in the donor's estate are the gift of a life insurance policy and gifts where certain rights or powers have been reserved by the donor. If the retained interest or power is transferred within three years of death, the property will be

includable in the donor's estate.

M. State Gift Taxes.

Ohio has no gift tax. However, there are eight states and one U.S. possession that impose state gift taxes: Connecticut, Delaware, Louisiana, New York, North Carolina, South Carolina, Tennessee, Wisconsin, and Puerto Rico.

N. Gift Tax Advantages over the Estate Tax.

Although the gift tax and estate tax rates are the same, there are gift tax advantages to making gifts during one's lifetime. A gift of property with potential appreciation will be removed from future appreciation in the donor's estate, and gifts of income-producing assets remove future income from the donor's estate. Even if the donee sells appreciated, gifted assets, the capital gains income tax may be as low as 15%, whereas the estate tax on the property, if not gifted, may be 41% to 48%.

Another advantage is that the gift tax is calculated only on the value of the gift made and not on the amount of the gift tax paid (provided that the gift is made more than three years before the donor's death). If property is transferred at death, the estate tax is calculated on both the value of the property transferred and on the property used to pay the estate tax. For example, assume that the donor has made prior gifts which have used up the transfer tax credit (\$1,500,000) and, as a result, places the donor in the 37% transfer tax bracket. If the donor now makes an additional taxable gift of \$100,000, the gift tax on this gift is equal to 37% of \$100,000, or \$37,000, and the total cost to the donor of the gift is \$137,000, but the donee nets \$100,000. On the other hand, if the donor does not make the gift and the \$100,000 is transferred at death, the estate tax is equal to 37% of \$137,000 (\$100,000 plus \$37,000), or \$50,690, and the total cost of the transfer would have been \$150,560. Thus, the lifetime gift would save \$13,690 in transfer taxes, even assuming no appreciation in the gift after lifetime transfer, to net the same gift to the donee.

O. Payment of Gift Tax.

Gift tax must be paid and reported on Form 709 on or before April 15th of the year following that in which the gift was made.

P. Gift Tax Statute of Limitations.

The IRS cannot revalue gifts for gift or estate tax purposes after the statute of limitations on the assessment of gift tax has expired. However, the period of limitations begins to run only if the gift is adequately disclosed on the gift tax return. A gift is adequately disclosed only if it is reported in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value reported. Gifts are considered adequately disclosed if the tax return or a statement attached to the tax return contains the following information.

1. A description of the transferred property and any consideration received by the transferor;

2. The identity of, and the relationship between, the transferor and the transferee;
3. If the property is transferred in trust, the trust's tax identification and either a brief description of the terms of the trust or a copy of the trust instrument;
4. Either a detailed description of the method used to determine the fair market value of the property transferred, including prescribed information, or an appraisal meeting stated requirements; and
5. A statement describing any position taken as contrary to any proposed, temporary or final regulation or published revenue ruling. Treas. Reg. § 301.6501(c)-1(f)(2).

A completed transfer to a member of the transferor's family that is made in the ordinary course of operating a business is deemed to be adequately disclosed, even if it is not reported on gift tax return, provided it is properly recorded by all parties for income tax purposes. Treas. Reg. § 301.6501(c)-1(f)(4).

Q. Custodial Accounts for Minors.

Under most state laws permitting the creation of custodial accounts of securities and other property for minors, the custodian generally has the discretionary power to distribute (apply), or withhold (accumulate) income, and to accelerate the distribution of principal for the minor's benefit. This is the kind of power which, if reserved by the grantor of a trust, could lead to the inclusion of the trust funds in the grantor's gross estate. The Treasury Department has determined that this rule is applicable to custodial accounts in the custody of the one who makes the gift (donor) if the donor is the custodian or successor custodian and dies while acting in that capacity before the minor attains majority. The same rule is applied to gifts under the Uniform Transfers to Minors Act. In other words, giving securities and other property to children through a custodial account may result in the transferred property being included in the donor's gross estate, unless someone other than the donor is named as the custodian of the gift.

R. Trusts for Minors.

Trusts can be created for minors taking advantage of the gift tax annual exclusion and other gifts. In order to accomplish this, the trust generally must provide that:

1. The income and principal of the trust may be used for the benefit of the minor until the minor reaches age 21; and
2. Any income and principal not used for the minor will pass to the minor upon reaching 21 years of age;

3. If the minor dies before reaching 21 years of age, the trust fund must be payable to his or her estate or to such persons appointed by the minor under a general power of appointment.

Nevertheless, there are creative trusts to avoid these rules, but this topic is beyond this outline.

XI. GENERATION-SKIPPING TRANSFER TAX

Although beyond the scope of this outline, caution should be taken to be aware of and plan for the generation-skipping transfer tax, if it applies. The generation-skipping transfer tax is imposed on outright gifts or transfers in trust or similar arrangement having beneficiaries more than one generation below that of the donor or grantor of the trust, such as grandchildren. Generation-skipping transfers by married persons are treated as made one-half by each spouse, pursuant to rules similar to the present gift-splitting rules on gifts to third parties. However, each transferor is permitted a \$1,120,000 specific exemption (2003) and \$1,500,000 specific exemption (2004).

XII. CONCLUSION

No one is legally obligated to pay any more tax than the legal rules require. The great Judge Learned Hand once said:

There is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

Tax avoidance (not tax evasion) is encouraged by law. The lawyer's job is to help his or her clients obtain that objective, consistent with the many, and often more important, nontax goals of estate planning.