CHAPTER 4

An Overview of the Estate, Gift, and Income Tax Rules Pertaining to Estates

MOORE MCLAUGHLIN and JILL SUGARMAN (Providence, Rhode Island)

Proper estate planning helps you accomplish many goals, including minimizing taxes. Even when considering your non-tax goals, the tax consequences of your choices should still be taken into account. You should focus on the wealth transfer taxes that could arise upon implementation of your estate plan. You must also anticipate the taxes that will be imposed upon your death. Lastly, income taxes may be assessed upon your estate during its administration. While estate planning certainly involves more than planning for these taxes, you do not want to overlook opportunities to pass on more wealth by reducing taxes whenever possible.

In any estate planning scenario, two basic federal taxes are involved: wealth transfer taxes and income taxes. Wealth transfer taxes consist of the gift tax and the estate tax. The gift tax is based on the value of assets transferred during your life. The estate tax is based on the value of assets transferred upon your death. In 2008, you are allowed to transfer up to $1 million in gifts tax-free during your life and up to $2 million (including gifts made during your life) upon your death. For deaths in 2009, the limit is $3.5 million. This amount is called the applicable exclusion amount. Additionally, you may generally transfer up to $12,000 ($13,000 in 2009) per year tax-free to any number of people. This amount is referred to as the annual gift tax exclusion.

Both the gift tax and the estate tax are based on the fair market value of the assets transferred; the determination of which has resulted in much litigation. The IRS has sanctioned several estate planning techniques based on determining the value of a present or future gift.

In many instances, especially if you have never undertaken any estate planning and depending upon the value and nature of your assets, your estate planning attorney may recommend making gifts; perhaps even in amounts exceeding the

lifetime $1 million exemption amount. Gift tax returns must be filed when gifts exceed the annual gift tax exclusion amount.

You must also account for the income tax consequences of your current gifts. You are not allowed an income tax deduction for gifts (except to certain charities), and the recipient of your gift reports no income. For gifts of assets that have increased in value since you acquired them, the recipient of your gift will take over your tax basis and holding period. Tax basis consists of the original amount paid for the asset, plus capital expenditures you make to the asset, less any depreciation deductions you are allowed. Basis is used to determine any taxable gain from the sale of your assets. Gain is the amount you receive from the sale of your asset reduced by your basis.

If your estate plan includes family limited partnerships and trusts, the income tax ramifications associated with such estate planning tools must be considered. Shifting your income tax burden to your children or a trust may result in overall income tax savings which can provide you with benefits in addition to the gift and estate tax savings.

In most estate plans for married couples, no federal estate tax is due upon the death of the first spouse. These plans typically take advantage of the unlimited marital deduction — your ability to transfer an unlimited amount of assets to your spouse during your life or upon your death — often by utilizing special trusts. In such instances, upon the death of the second spouse, the estate tax will be imposed on the value of the assets the surviving spouse owns when he or she dies, including life insurance policies, joint accounts, and certain interests in trusts.

In contrast to gifts you make during your lifetime, your beneficiaries at death will inherit your assets with a "stepped-up" basis — the fair market value of the assets on the date of your death. This step up (or step down) in basis effectively eliminates any gain (or loss) if the assets are sold soon after your death. Under this scenario, enormous tax savings can result. An experienced estate planning attorney can help you make these calculations and determine the best course of action between making gifts during life or planning to transfer your assets upon death.

In addition to the Federal estate tax return for estates exceeding the applicable exclusion amount, a final income tax return, which includes all income received prior to death, must be filed on behalf of the decedent.

Upon death, a new taxpayer — the estate — is created. The estate may receive income and pay expenses prior to making final distributions. If so, then an income tax return will be required to be filed on behalf of the estate. The types of income received by the estate may include salary or wages during the final pay period, certain retirement accounts, accrued rents, interest, and dividends. The estate is also allowed certain deductions against the income, such as administrative expenses and fiduciary fees. Whether the estate is required to pay taxes, or whether the beneficiaries of the estate will bear this burden, is determined under a complex set of rules.

You must consider many taxes in the course of preparing and implementing your

estate plan. While focusing on gift and estate taxes, you must not forget about income tax. Engaging an experienced estate planning team, including an attorney, CPA, and financial advisor, is your best avenue for avoiding or minimizing these taxes.

McLaughlin & Quinn, LLC (www.mclaughlinquinn.com) is a law firm focused on preserving wealth through estate planning, asset protection planning, income tax planning, IRS and state tax representation, and bankruptcy.

Gift Tax Formula

1.	Total gifts in current year (fair market value of all gifts)		$_______
2.	**LESS:**		
	One-half of value of gifts split with spouse	$_______	
	Annual exclusions ($12,000 per donee for present interests, and $13,000 in 2009)	$_______	
	Marital deduction	$_______	
	Charitable deduction	$_______	
	Total Subtractions		($_______)
3.	**EQUALS:** Taxable gifts in current year		$_______
4.	**ADD:** Taxable gifts made in prior years		$_______
5.	**EQUALS:** Total taxable gifts to date (tax base)		$_______
6.	Tentative tax on total taxable gifts to date		$_______
7.	**LESS:** Tax paid or deemed paid on prior taxable gifts		($_______)
8.	**EQUALS:** Gift tax on current year taxable gifts before applicable credit amount		$_______
9.	**LESS:** Applicable credit amount ($345,800)		($_______)
10.	**EQUALS:** Gift tax due on current year taxable gifts		$_______

Estate Tax Formula

1.	Gross Estate		$________
2.	**LESS: EXPENSES, DEBTS, AND LOSSES**		
	Funeral and administrative expenses	$________	
	Debts of decedent, mortgages, losses	$________	
	Medical expenses	$________	
	Unpaid taxes	$________	
	Total Expenses, Debts, and Losses		($________)
3.	**EQUALS:** Adjusted Gross Estate (AGE)		$________
4.	**LESS: TOTAL ALLOWABLE DEDUCTIONS**		
	Charitable deduction	$________	
	Marital deduction	$________	
	State death taxes paid	$________	
	Total Allowable Deductions		($________)
5.	**EQUALS:** Taxable estate		$________
6.	**ADD:** Adjusted taxable gifts (post-1976)		$________
7.	**COMPUTE:** Tentative tax base		($________)
8.	**COMPUTE:** Tentative tax		$________
9.	**LESS:** Tax paid or deemed paid on prior taxable gifts		($________)
10.	**EQUALS:** Estate tax before reduction for allowable credits		$________
11.	**LESS:**		
	Applicable credit amount	$________	
	Other credits	$________	
	Total Subtractions		($________)
12.	**EQUALS:** Estate tax liability		$________

2008 Unified Federal Estate and Gift Tax Rate Schedule

IF THE TAXABLE AMOUNT IS:	THE TENTATIVE TAX IS:
Over $0 but not over $10,000	18%
Over $10,000 but not over $20,000	$1,800 plus 20% of the excess over $10,000
Over $20,000 but not over $40,000	$3,800 plus 22% of the excess over $20,000
Over $40,000 but not over $60,000	$8,200 plus 24% of the excess over $40,000
Over $60,000 but not over $80,000	$13,000 plus 26% of the excess over $60,000
Over $80,000 but not over $100,000	$18,200 plus 28% of the excess over $80,000
Over $100,000 but not over $150,000	$23,800 plus 30% of the excess over $100,000
Over $150,000 but not over $250,000	$38,800 plus 32% of the excess over $150,000
Over $250,000 but not over $500,000	$70,800 plus 34% of the excess over $250,000
Over $500,000 but not over $750,000	$155,800 plus 37% of the excess over $500,000
Over $750,000 but not over $1,000,000	$248,300 plus 39% of the excess over $750,000
Over $1,000,000 but not over $1,250,000	$345,800 plus 41% of the excess over $1,000,000
Over $1,250,000 but not over $1,500,000	$448,300 plus 43% of the excess over $1,250,000
Over $1,500,000	$555,800 plus 45% of the excess over $1,500,000

Estates and Gifts: Applicable Credit and Applicable Exclusion Amount

For Transfers Made in	ESTATES		GIFTS	
	The Credit is	Taxable Estate Exclusion	The Credit is	Taxable Gift Exclusion
1987-1997	$192,800	$600,000	$192,800	$600,000
1998	$202,050	$625,000	$202,050	$625,000
1999	$211,300	$650,000	$211,300	$650,000
2000-2001	$220,550	$675,000	$220,550	$675,000
2002-2003	$345,800	$1,000,000	$345,800	$1,000,000
2004-2005	$555,800	$1,500,000	$345,800	$1,000,000
2006-2008	$780,800	$2,000,000	$345,800	$1,000,000
2009	$1,455,800	$3,500,000	$345,800	$1,000,000
2010	Estate tax repealed	Estate tax repealed	$345,800	$1,000,000
2011	$345,800	$1,000,000	$345,800	$1,000,000

To illustrate the gift, estate, and income tax aspects of estate planning, consider the following sequence of examples.

EXAMPLE 1: Assume you, as a single person, purchase stock in 2004 for $300,000. In 2006, the stock value appreciates to $512,000 and you gift the stock to your daughter. The amount of gift tax you owe is zero, calculated as follows:

Fair market value of the gift	$512,000
Annual exclusion	(12,000)
Taxable gift	500,000
Tentative gift tax	$155,800
Unified credit ($345,800, limited to tentative tax)	(155,800)
Gift tax due for 2006	0

For income tax purposes, your daughter is deemed to have purchased the stock when you did in 2004, giving her a basis in the stock of $300,000 for determining long-term or short-term capital gain.

EXAMPLE 2: Continuing Example 1, assume you purchased other stock for $800,000 in 2003. By 2007, the value of the stock has decreased to $762,000 and you gift the stock to an irrevocable trust for the benefit of your son. The amount of gift tax you owe is calculated as follows:

Fair market value of the gift		$ 762,000
Less: Annual exclusion		(12,000)
Taxable gift for the current year		750,000
Add: prior taxable gifts	(gift to daughter in 2006)	500,000
Total taxable gifts		$1,250,000
Tentative gift tax		448,300
Less: deemed gift tax paid in 2006		(155,800)
Less: unused unified credit ($345,800 – 155,800)		(190,000)
Gift tax due on Form 709 for 2007		$102,500

Because the value of the stock is less than your purchase price, the trust's income tax basis is not adjusted for the gift tax paid and cannot be determined at the time of the gift. If the trust sells the stock shares for less than its fair market value at the time of the gift ($762,000 total), its basis for loss is the fair market value ($762,000 total) at the time of the gift and its holding period starts on the day of the gift. If it sells the stock for more than your basis ($800,000), the trust's basis for gain is your basis ($800,000) and its holding period includes the time you owned the stock. If it sells the stock for an amount between $762,000 and $800,000, the trust reports no gain or loss.

EXAMPLE 3: The trust funded in Example 2 will report its income from the trust assets (interest, dividend, rent, and gains from the sale of assets) on a separate trust tax return (Form 1041) unless the trust is taxable

to the grantor because the grantor retained control over the trust. The trust tax rates are very high, reaching the 35% marginal tax rate bracket on income greater than $10,450. These rates can be avoided if the trust distributes its income to its beneficiaries (e.g., the son).

EXAMPLE 4: Building further on Examples 1 and 2, assume you die in 2008 with $3,000,000 in stocks and bonds. Your executor pays: outstanding debts of $100,000; administrative expenses, including burial expenses, of $50,000; state death taxes to your state of residence of $75,000; and $150,000 to your favorite charity. Your estate tax is calculated as follows:

Gross estate	$3,000,000
Add: gift taxes paid in 2007	
(included in the estate because paid within 3 years of death)	102,500
Less: debts	(100,000)
Less: administrative expenses	(50,000)
Less: state death taxes	(75,000)
Less: charitable contributions	(150,000)
Tentative gross estate	2,727,500
Add: post-1976 gifts	1,250,000
Taxable estate	3,977,500
Tentative tax	1,670,675
Less: gift tax paid since 1976	(102,500)
Less: unified credit	(780,800)
Estate tax due with Form 706	787,375

The income tax basis of the $2,625,000 ($3,000,000 – 100,000 – 50,000 – 75,000 – 150,000) in assets passing to the heirs after estate obligations will step up or step down to $2,625,000. Any sales of assets will be treated as long-term even if the holding period of the asset to the decedent and subsequent heirs is less than one year.

EXAMPLE 5: Continuing examples 1-4, unless the assets you own avoid probate because they were owned by a trust, jointly owned with rights of survivorship, or transferred by some other probate-avoidance mechanism, they will be administered by your personal representative. Any income earned by the assets, such as interest, dividends, rent, and gains from sale, during the time they are held by the representative before distribution to the eventual heirs will be subject to the same high tax rates as the trust described in Example 3. The personal representative will report this income on a separate return for the estate (Form 1041). Similar to a trust, the estate can avoid this income tax by distributing the income to beneficiaries.