Estate Tax Overview

Emphasis on Generation Skipping Transfers

A Brief History - 1916

- The Revenue Act of 1916 (39 Stat. 756) created a tax on the transfer of wealth from an estate to its beneficiaries, and thus was levied on the estate, as opposed to an inheritance tax that is levied directly on beneficiaries. It applied to net estates, defined as the total property owned by a decedent, the gross estate, less deductions. An exemption of $50,000 was allowed for residents; however nonresidents who owned property in the United States received no ex-emption.

The Tax Act of 1981

- The Economic Recovery Tax Act (ERTA) of 1981 (95 Stat. 172) increased the unified transfer tax credit, the credit available against both the gift and estate taxes. The increase, from $47,000 to $192,800, was to be phased in over 6 years, effectively raising the tax exemption from $175,625 to $600,000 over the same period.
- In 1997, the 105th Congress passed the Taxpayer Relief Act of 1997 (111 Stat. 788). Among the most significant changes to estate and gift tax laws included in this act was the incremental increase of the unified credit to $345,800 by 2006, effectively raising the estate tax filing threshold to $1 million.

The Tax Act of 2001

- The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 (115 Stat. 38) provided for sweeping changes to the transfer tax system, the most significant of which was the eventual repeal of the estate tax for 2010. Specifically, the law provided for periodic increases in the exemption amount for decedents who die after December 31, 2001, so that the effective filing threshold will be $3.5 million by 2009, then repealed for decedents who died in 2010.

Current Federal Estate Tax

- The federal estate and generation-skipping transfer taxes were resurrected by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) after a hiatus of one year (2010). The American Taxpayer Relief Act of 2012 (ATRA) permanently extended the estate tax rules enacted by the 2010 Act except for the top tax rate, which increased from 35% to 40% for both the estate and gift taxes.
- The federal estate tax is a tax on the estate of a decedent, levied against and paid by the estate. Contrastingly, the inheritance tax is imposed on and paid by the heirs of the decedent based upon the money or property that they receive. The determination of federal estate tax liability involves a series of adjustments and modifications of a tax base known as the "gross estate." Certain allowable deductions reduce the gross estate to the "taxable estate." Then, the total of all lifetime taxable gifts made by the decedent is added to the taxable estate before tax rates are applied. The result is the decedent's estate tax which, after reduction for certain allowable credits, is the amount of tax paid by the estate. This discussion will divide the federal estate tax into three components: the gross estate, deductions from the gross estate, and computation of the tax, including allowable tax credits.

CURRENT ESTATE TAX SCHEDULE

- The estate rate schedule is as follows:

Taxable Estate	Tentative Tax
not over $10,000	18% of such amount
$10,000-$20,000	$1,800 + 20% of excess over $10,000
$20,000-$40,000	$3,800 + 22% of excess over $20,000
$40,000-$60,000	$8,200 + 24% of excess over $40,000
$60,000-$80,000	$13,000 + 26% of excess over $60,000
$80,000-$100,000	$18,200 + 28% of excess over $80,000
$100,000-$150,000	$23,800 + 30% of excess over $100,000
$150,000-$250,000	$38,800 + 32% of excess over $150,000
$250,000-$500,000	$70,800 + 34% of excess over $250,000
$500,000 -$750,000	$155,800 + 37% of excess over $500,000
$750,000 -$1,000,000	$248,300 + 39% of excess over $750,000
Over $1,000,000	$345,800 + 40% of excess over $1,000,000

Myth 1: The estate tax is best characterized as the "death tax."

- **Reality: Everybody dies, but only the richest 0.14 percent of estates pay any estate tax.**
- The estate tax is best characterized as a tax on very large inheritances by a small group of wealthy heirs. Today, only the estates of the wealthiest 0.14 percent of Americans.
- Fewer than 2 out of every 1,000 people who die — owe any estate tax whatsoever because of the high exemption amount, which has more than quadrupled since 2001.

Myth 2: The estate tax forces estates to turn over half of their assets to the government.

- **Reality: The few estates that pay any estate tax generally pay less than one-sixth of the value of the estate in tax.**

- Today, 99.86 percent of estates owe no estate tax at all, according to the Brookings Tax Policy Center (TPC). Among the 3,780 estates that owe any tax, the "effective" tax rate — that is, the percentage of the estate's value that is paid in taxes — is 16.6 percent, on average. That is far below the top estate tax rate of 40 percent. The effective rate is so much lower than the top rate for several reasons. First, estate taxes are due only on the portion of an estate's value that exceeds the exemption level; at the current exemption level of $5.25 million, a $6 million estate would owe estate taxes on $750,000 at most. Second, heirs can often shield a large portion of an estate's remaining value from taxation through various deductions.

Myth 3: Many family-owned farms and businesses must be liquidated to pay taxes.

- **Reality: Only a handful of small, family-owned farms and businesses owe any estate tax at all, and virtually none would have to be liquidated to pay the estate tax.**

- Brookings Tax Policy Institute estimates that only *20* small business and farm estates nationwide owed *any* estate tax for deaths in 2013. (TPC's analysis defined a small-business estate as one with more than half its value in a farm or business and with the farm or business assets valued at less than $5 million.) This figure represents only 0.00075 percent of all estates — that is, about one out of every 130,000 estates of people who died during the year 2013. Furthermore, these 20 estates will owe just 4.9 percent of their value in tax, on average.

GENERATION SKIPPING TAX

- The Tax Reform Act of 1986 repealed the original generation-skipping transfer (GST) tax, enacted in 1976, because of its complexity and replaced it with a simplified flat-rate tax. The purpose of the resulting GST tax is the same as its predecessor, to close a loophole in the estate and gift tax system where property could be transferred to successive generations without paying multiple estate or gift taxes. The traditional generation-skipping transfers were trusts established by a parent for the lifetime benefit of the children with the remainder passing to the grandchildren. If properly drafted, an estate or gift tax would not be imposed when the trust corpus passed from the settlor’s children to the settlor’s grandchildren because the estate tax is not imposed on interests that terminate at death. This discussion will divide the generation-skipping transfer tax into two components: generation-skipping transfers and the computation of the tax.

GENERATION SKIPPING TAX

- The GST tax is a flat-rate tax. The rate is set at the highest estate tax rate, currently 40%. This tax rate is applied to three different transfer events: a direct skip, a taxable termination, or a taxable distribution. A direct skip is a transfer to a skip person. A skip person is a person assigned to a generation two or more generations below the transferor's. A transfer to a trust is a direct skip if all the interests in the trust are held by skip persons. A taxable termination is a termination by death, lapse of time, release of power, or otherwise of an interest in property held in trust. A taxable termination does not occur if immediately after the termination a non-skip person has an interest in the property or if after the termination, the trust makes a distribution to a skip person. A taxable distribution is a distribution from a trust, other than a taxable termination or direct skip, to a skip person.

Highlights of Generation Skipping Transfer Tax

- Three systems – Estate, Gift and GSTT
- GSTT is an excise tax imposed on the transfer of property to a donee who is two or more generations younger than the donor
- On top of estate and gift tax
- GSTT rate is equal to the maximum estate tax rate in effect at the time the generation-skipping transfer (GST) occurs *times* the "inclusion ratio"

Important Step of GST

- An important step in determining the GST tax is to assign all persons involved to a specific generation level, as outlined in the IRC. Persons related to the transferor or spouse are assigned along family lines. For example, the transferor, spouse, and brothers and sisters are in one generation, their children in the next, and grandchildren in the next. Lineal descendants of a grandparent of the transferor or spouse are assigned to generations on the same basis. Anyone ever married to a lineal descendant of the transferor's grandparent or the spouse's grandparent are assigned to the level of their spouse who was a lineal descendant. Non-relatives of the transferor are assigned generations measured from the birth of the transferor. Persons not more than 121⁄2 years younger are treated as members of the same generation as the transferor. Each 25-year period thereafter is treated as a new generation. A grandchild of the transferor or spouse is moved up one generation if his parents are deceased at the time of the transfer.

Computing GST

- The first step in calculating the GST tax is to determine the taxable amount. For direct skips, the taxable amount is the value of the property received by the transferee. The GST tax on direct skips is tax-exclusive, meaning that the amount of tax paid is proportional to the pretax value of the transferred property. Contrastingly, the taxable amount for taxable terminations and distributions is tax-inclusive. The taxable amount for these property transfers is determined by including the tax value with the value of the property before applying the tax rate. The second step in calculating the GST tax is to apply the applicable rate. The applicable rate is the maximum Federal estate tax rate (40% for 2014) and the inclusion ratio of the transfer. The inclusion ratio is figured by subtracting from one ("1") the following fraction: the portion of the GST exemption allocated to the transfer as the numerator and the value of the property transferred as the denominator. To compute the generation-skipping tax, the value of the transfer is multiplied by the tax rate (40%) and by the inclusion ratio.
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- The IRC provides several exemptions and exclusions for the GST tax. Unlike the estate and gift taxes, the GST tax does not use the unified credit. Instead, a $5,340,000 GST exemption is allowed to each individual for generation-skipping transfers during life or at death.61 The exemption is doubled for married individuals who elect to treat the transfers as made one-half by each spouse. An indirect skip property transfer automatically triggers the GST exemption.

Parties Involved in Generation Skipping Transfers (1 of 5)

- Transferor
  - If transferred during life and is subject to gift tax then the transferor is the donor
  - If transferred at death and subject to estate tax, the “transferor” is the decedent
  - A new transferor is established whenever the property is again subject to estate tax or gift tax
- Transferee
  - Non-Skip Person
    - A non-skip person is any natural person or trust that is not a skip person

Parties Involved in Generation Skipping Transfers (3 of 5)

- Transferee
  - Skip Person
    - Lineal Descendants
      - Two or more generations younger than the transferor are skip persons
    - Unrelated and Non-Lineal Descendants
      - If the individuals receiving the property are not lineal descendants of the transferor, they are considered skip persons if they are more than 37½ years younger than the transferor
        - » Your generation includes anyone 12 ½ years younger and older.
        - » Individual age 60: his generation 47 ½ - 72 ½
        - » Next generation 22 ½ - 47 ½
        - » Skip generation under age 22 ½

Parties Involved in Generation Skipping Transfers (5 of 5)

- Transferee
  - Skip person
    - Trust may be skip person if:
      - All interests in the trust are held by skip persons or
      - If distributions can only be made to skip persons
  - Predeceased ancestor rule
    - If a child of the transferor is deceased at the time of the transfer then the deceased child's descendents are moved up one generation.

Types of Taxable Transfers (1 of 3)

- Direct Skip
  - Outright gift to a skip person
    - Direct skips are taxed only once regardless of how many generations are skipped
    - GSTT on a direct skip is imposed only on the amount received by the transferee
    - Any GSTT associated with a direct skip that is paid by the transferor is treated as a taxable gift by the transferor
    - The transferor is generally liable for the GSTT on a direct skip
    - If a direct skip is made from a trust, the trustee is liable

Types of Taxable Transfers (1 of 3)

- Taxable termination
  - A taxable termination is any termination of a trust interest unless at the termination of the trust, the trust property transferred is subject to
    - federal estate or gift tax,
    - a non-skip person receives an interest in the property transferred out of the trust, or
    - the distribution from the trust will never be made to a skip person.
  - Taxable amount equals the value of the trust property transferred less any expenses, indebtedness and taxes attributed to the termination
  - Trustee is liable for the GSTT on a taxable termination

Types of Taxable Transfers (1 of 3)

- Taxable distribution
  - Any distribution from a trust to a skip person that is not a taxable termination or a direct skip
  - Taxable amount equals amount received by the recipient
  - Transferee is liable for the GSTT on a taxable distribution

Exclusions (1 of 4)

- Qualified Transfers
  - Payment of tuition to a qualified educational organization on behalf of a skip person is not subject to GSTT
  - Payment of medical expenses to a medical care provider on behalf of a skip person is not subject to GSTT

Exclusions (3 of 4)

- Annual Exclusion
  - A direct skip is a nontaxable gift for GSTT purposes to the extent the transfer is excluded from taxable gifts under the annual gift tax exclusion
- Split gifts
  - Gift splitting also applies to transfers subject to GSTT
  - Enables a spouse to treat gifts of separate property as being made 1/2 from each spouse
  - If an individual elects to split gifts for gift tax purposes, they are automatically deemed to split gifts for GSTT purposes and vice versa.

Exclusions (4 of 4)

- Annual Exclusion
  - Transfers to a trust deemed a skip person are only considered nontaxable gifts for GSTT purposes to the extent the transfer is equal to or less than the annual exclusion and if:
    - The beneficiaries are given a Crummey power
    - The trust assets can only be distributed for the benefit of the beneficiary during the beneficiary's lifetime; and
    - The trust does not terminate before the beneficiary's death, and the assets must be includible in the beneficiary's gross estate.

Exemption (1 of 2)

- GST Exemption
  - Exemption of $5,340,000 for 2014
  - The GSTT exemption is allocable to inter vivos transfers and testamentary transfers
  - Only the transferor or the transferor’s executor can allocate the GST exemption to a transfer and such allocation is irrevocable
  - If a direct skip occurs during the transferor’s lifetime then the transferor’s unused GST exemption is automatically allocated to the transferred property to the extent necessary to make the inclusion ratio for such property zero

Exemption (1 of 2)

- GST Exemption
  - The transferor may elect out
  - Automatically allocated at death to the extent not actually allocated on or before the due date for the transferor’s estate tax return
    - First allocated pro rata to direct skips
    - Remaining GST exemption allocated pro rata to trusts

Applicable Rate, Inclusion Ratio and Applicable Fraction

- Application Fraction= GST exemption/ Taxable Property Transferred
- Inclusion Ratio = 100% - Applicable Fraction
- Applicable Rate = Inclusion Ratio x Maximum Transfer Rate (currently 40%)

Qualified Disclaimers

- Effect of Qualified Disclaimers
  - A qualified disclaimer may not be used to avoid generation-skipping transfer tax

Introduction to Dynasty Trusts (1 of 4)

- When properly drafted, a dynasty trust will not vest ownership of trust property in any individual beneficiary
- The rule against perpetuities
  - Delaware, Alaska and S. Dakota are the states where most individuals create dynasty trusts
- Taxation of dynasty trusts
  - A dynasty trust pays tax on its income to the extent that the income is not distributed to the beneficiaries

Introduction to Dynasty Trusts (2 of 4)

- Basic Structure and Types of Dynasty Trusts
  - Grantor funds the trust with personal property
    - Typically ownership of family business
    - Transfer real estate to LLC or FLP
  - Trust document usually designates the state whose laws will govern
  - Usually wise to name two independent trustees
    - Individual: successors?
  - Typically name two or more “Trust Protectors” who are individuals that are not beneficiaries of the trust with the authority to remove the trustee
  - Grantor should never serve as trustee or trust protector of a dynasty trust

Introduction to Dynasty Trusts (3 of 4)

- Basic Structure and Types of Dynasty Trusts
  - The trust instrument often gives the trustee the authority to terminate the trust in whole or in part if it is appropriate to do so
  - Trustee is typically empowered to purchase assets for the beneficiary’s personal use
  - Later generation can contribute to trust, if desired
    - Generational sub-trust generally necessary otherwise splitting assets transferred with distant cousins
  - A dynasty trust provides creditor protection, avoidance of transfer taxation at each generational level on the value of the business, as well as protection from the claims of a divorcing spouse

General Drafting Issues for Dynasty Trusts

- Power of appointment – usually available
  - Limited to prevent inclusion in estate
- Termination – usually ends when last descendent dies
  - May have trust committee giving them the ability to terminate
    - Tax law changes, too small to justify administration expense
- Trustee – broad investment powers
  - Not require diversification if holding family business
- Spendthrift clause appropriate