

# **CHAPTER TWO – Federal Transfer Tax Structure**

**Federal tax structures:**

## **1) Transfer taxes –**

- Estate tax (transfers at time of death)**
- Gift tax (transfers during lifetime)**
- Generation skipping transfer tax (GSTT)**

## **2) Income tax –**

- Tax basis rules (§§ 1014, 1015)**
- §102 – inheritances & gifts as gross income**
- Subchapter J – trust income taxation**
- “Assignment of income” doctrine**

# Evolution of the Current Federal Estate Tax

Pre-2001 (exemption up to \$700,000)

Pre-2010 (2002 thru 2009, increasing exclusion).

The year 2010 – repeal (but carryover basis applies); then, 2011 back to 2001 regime.

Cf., retention of the gift tax during phase-out.

But, then, 2010 Tax Act - 12-17-2010

Estate tax restored, \$5 million exclusion, including for gift tax; \$5.12 mil for 2012.

Then 2012/ 2013 legislation. A “permanent fix”?

# Evolution of the Current Federal Estate Tax, cont.

See chart, p. 9.

Exclusion for 2017 was projected to be \$5.6 million per estate.

Tax Cuts & Jobs Act, 12-22-2017:

doubling of estate tax exclusion to \$10 million (\$11.4 million as indexed for 2019) until 2026, & then reverting to \$5 million, as indexed.

Code §2010(c)(3)(C).

# Objectives in Imposing the Federal Estate Tax

- 1) Revenue – How much? \$30 Billion? \$8 billion? What % of total federal tax revenue? Is the % amount relevant for tax policy reasons?
- 2) Consider: Economically accrued “income” not previously subject to income tax, e.g., §1014 basis step-up; i.e., “tax justice.”
- 3) Reduction of wealth concentration – is this a valid objective/public policy concern?

# Economic Effects of the Estate Tax

Is the estate tax detrimental to small business?  
Are small businesses and family farms actually being impeded by estate tax? Or benefitted by estate tax payment deferral options?

What is a “small business” for this purpose?

Cf., argument re income tax on taxpayers at top rate (\$400,000+, as indexed), and the impact on small businesses.

# Alternatives to Estate Tax ("Death Tax") p.10

Inheritance tax – imposed on the recipient; tax rate is based on the relationship of recipient to the decedent. But, collection occurs at source.

Accessions tax – tax on the cumulative total of value received by a person during lifetime.

Income tax - inclusion in the gross income of a bequest (& gift) amount (i.e., repeal IRC §102).

Net worth tax (imposed on a periodic basis) – a property ownership tax. Constitutional?

# Effect of Carryover Basis (vs. Estate Tax) p.11

Estate tax: imposed at the rate of (then) 35% above a \$5.0 mil. exemption equivalent.

Carryover basis structure (2010): Capital gains rate (then 15%, presently 20%) above a minimum basis step-up allowance amount; deferred income tax (& consider value of deferral). Most opted for carryover basis.

See §1022 re carryover basis (& exceptions).

But, downward shifting of tax liability? P.11.

# **Structure of the Federal Estate Tax**

**p.12**

## Computation:

**Gross estate**

**Less: Deductions**

**Equals: Taxable estate**

**Less: Credits**

**Equals: Net estate tax liability.**

**Note similarity to the net income tax structure.**

# Gross Estate Defined - “economic rights”? p.12

Gross estate inclusion (§2031):

- Probate assets – property owned directly -§2033 i.e., property where the decedent has an interest.
  - tax-exempt bonds (Code §103)?
  - accrued rent and interest income?
  - other assets, e.g. contingent claims
- Some transfers made within 3 years of death –
  - including the gift tax paid - § 2035(b); gift tax as an “exclusive” tax. Estate tax as “inclusive.”
- Cf., income tax is imposed on a pre-tax amount.

# **Gross Estate Defined - “economic rights”? p.14**

Gross estate inclusion: §§2036-2038

- Transfers with retained interest or controls

(1) Grantor retained economic interests

E.g, a revocable (“living”) trust

- a retained income & corpus interest

(2) Grantor retains control – other beneficiary

E.g., retained right to control distributions.

- Survivorship annuities - §2039

applies to annuity with a survivorship payment; cf., treatment of a single life annuity for only the decedent.

# **Gross Estate Defined - “economic rights”? p.15**

**Gross estate inclusion for:**

- **JTWROS property (decedent’s funds) - §2040**  
**Issue: Who provided the consideration?**
- **“Power of appointment” property - §2041**  
**property subject to decedent’s control - but  
power originally sourced from another.**
- **Life insurance proceeds - §2042 p.16**  
**if decedent holds “incidents of ownership.”**
- **Transfers from the decedent’s spouse - §2044**  
**(see §2056 enabling prior marital deduction).**

# **Deductions reducing the gross estate** **p.17**

- Expenses & debts (genuine debts?) §2053
  - Losses (e.g., casualties incurred during Administration, e.g., hurricane) - §2054
  - Charitable transfers – §2055 - no limit on this deduction (including split-interest gifts)
  - Spousal transfers (QTIP trusts) §2056
  - State death taxes (not relevant in Texas); p.19
- Prior credit for state death taxes. p.21.
- Cf., credit for foreign tax paid - §2014. (p. 22).

# Estate tax liability computation

p.19

§2051 – taxable estate defined (P. 19).

Cumulative transfer tax base – including prior lifetime gift transfers (a unified tax base).

Credit for any gift tax paid on prior lifetime transfers.

Less: Other credits (i.e., unified credit & foreign tax credit; previously for state death tax paid), p.20-22.

Cf., federal gift tax (tax exclusive applicability)

# Federal Gift Tax p.23

## 40% above \$10 million+

§2501 – imposition of this tax on gifts- imposed on a lifetime, cumulative basis. Still applied in 2010 when the estate tax was repealed. Why?

Certain exclusions (e.g., annual donee exclusion) & deductions are available.

& \$10 million exclusion (as indexed).

*Smith* case (p.24) – re effect of subsequent gift tax revaluations on the federal estate tax calculation (i.e., consider (1) the applicable tax rate and (2) the offset for gift tax payable).

Legislative response – Enactment of §2001(f).

# Generation skipping transfer tax

p.36

Purpose of the GSTT?

Situations when GSTT is applicable – transfers (1) during lifetime, (2) at death, & (3) when a later trust distribution occurs.

A separate GSTT is imposed (in addition to other transfer taxes).

Code §§2601-2604 (also expired for year 2010).

Reinstated for 2011 & later - \$5 million exemption, as indexed; now \$10 million+

# Relevance of State Property & Inheritance Laws to Estate Planning?

How define the governing state law? Consider the *Bosch* case impact: state lower court proceedings determine the “property facts.”

When is the federal tax proceeding bound by the applicable state law? Cf., *Erie v. Tompkins*.

Can the IRS be bound by prior proceedings in a state probate (or other) court? If not a party?

*Bosch* case (p.40): “proper regard” treatment is required for the related state court proceeding.

# **Conflict of laws issues**

## **p.42**

**Choices of applicable law issues arising in:**

- 1) the property transfer/probate context?**
- 2) Federal transfer tax context (consider the Bosch case)?**
- 3) State estate/inheritance tax context?**

**Examples:**

**Land, e.g., 2<sup>nd</sup> home or ranch in other state;**  
**Corporate stock certificate (or equivalent);**  
**Other intangibles located outside home state.**

# **Conflict of law issues, Special considerations**

**Community property issues (i.e., identifying community property, including when transported across state lines into a separate property jurisdiction); or when moving from separate to community state.**

**Use planning to change the situs of property (e.g., with revocable trust ownership governed by law of other state)?**

**What property law treatment of U.S. Treasury bonds/notes – a special federal “property law” regime?**

# Valuation Issues

## p.43

What is an appropriate valuation approach for federal estate tax purposes? See Reg. §20.2031-1(b) re the “willing buyer-willing seller” valuation definition.

What assets present valuation difficulties?  
How is this valuation to occur?

Consider the O’Keeffe case (p.44) & similar decisions (e.g., art, real estate and FLPs). How does the taxpayer’s counsel develop an estate tax valuation case before/during litigation?

Other valuation issues? M. Jackson’s “name”?

# Valuation & the Impact of Built-in Tax Costs

How value corporate stock when the “inside assets” have significant accrued appreciation? (See p. 55).

Note: Corporate cap gains tax at 35%(?); 20%.

See Dunn case (p. 56) in the 5<sup>th</sup> Circuit, & similar decisions. What relevance (if any) of the expectation of a near-term sale of the assets inside the corporation?

How is stock valued by a prospective buyer in an anticipated stock purchase transaction?

# **Valuation of Split Interests in Property p.60**

How proceed to value a split interests in property (vertical or horizontal)?

E.g., ownership of only a partial interest:

- 1) a lead interest,
- 2) a remainder interest (after a term or after a life?), or
- 3) a reversionary interest?

See Reg. §20.2031-7(d)(6), Table B & (d)(7), Table S; what exceptions apply to the use of these tables? See O'Reilly case, p. 60.

**What is the impact of high/low interest rates?**

# Federal Income Tax – Gifts & Bequests p.61

Gifts & bequests are not included in gross income - §102 – even though they constitute an “accession to wealth.” Except, see §2801 re “covered gifts” from “covered expatriates.”

What about the “income” subsequently derived from the gift/bequest property? Gift of an “income stream” (e.g., life interest)?

See §102(b) – no exclusion is available for the income component from property received in gratuitous transfers.

# **Income Tax Basis Issues**

## **p.61**

**Income tax basis step-up at death? See §1014 (pre & post-2010). No gain recognition at death.**

**What tax expenditure cost? \$35 billion (2018) (per Joint Committee, JCX-3-17, p. 33).**

**Note (p. 62) the 2015 enactment of §1014(f) re a “consistency rule” (enacted in the Surface Transportation Act) – only when filing an estate tax return is required.**

# **Income Tax Basis Step-Up Impact p.61**

Is appreciated property held to get benefit of basis step-up, i.e., a “lock-up effect” occurs?

Possible to freeze the accumulated gain until basis step-up occurs? Use (1) an option or (2) “sale against the box” – but §1259 re current gain realization, or (3) borrow against property.

Other tax policy alternatives re tax basis at death? P. 62.

- carryover basis at death (applicable in 2010).
- income taxation (of appreciation) at death.

# Income Tax Basis Issues

Connecticut National Bank case, p. 63.

What is the application of §1014 when funding from the probate estate is delayed (example: widow dies as beneficiary of an unfunded marital deduction trust)?

**Result:** The “equitable interest” benefits from §1014 basis step-up when widow dies.

**Prior history:** Increase in estate for estate tax purposes; here, litigation re federal income tax.

# Limit on Income Tax Basis Step-up

A limit on §1014 applies (i.e., no tax basis step-up) when IRD is received. See §1014(c) & §691 providing for GI inclusion (for a cash basis taxpayer; cf., accrual basis taxpayer).

What is “income in respect of a decedent”?

E.g., account with deferred comp.

Accrued interest? Accrued rental income?

# **Gifts & Transferred Income Tax Basis p.68**

What about transferred tax basis to a donee for intervivos gifts? See §1015 & Taft v. Bowers.

See §7701(a)(43) re transferred basis property – received from the donor.

§1015(d)(6) – special adjustment for that gift tax (if any) attributable to the appreciation component of gifted property. This adjustment only relevant to quite large estates (when transfer tax is incurred).

# Estate Tax Administration Issues

- 1) Estate tax return filing requirements – responsibility of the executor.
- 2) Audit examinations by IRS?
- 3) Possible to obtain an estate or gift tax private letter ruling (i.e., in advance) from IRS? P. 69.

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