



Estate And Gift Tax

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Background

One of the oldest methods of [TAXATION](#) is the taxation of property held by an individual at the time of death. At that time the estate passed from one individual to another or several others. Estate and gift taxes are imposed on large transfers of money and/or property. Most gifts are not subject to the gift tax and most estates are not subject to the estate tax. Gift taxes are imposed on transfers made during an individual's lifetime. Estate taxes are imposed on transfers made as a result of death. Although gift taxes and estate taxes are paid separately, they are a unified tax in the sense that a single graduated rate schedule applies to the cumulative total of taxable transfers made through gifts and estates. An estate tax is a charge upon the decedent's entire estate, regardless of how it is disbursed. An alternative form of death tax is an [INHERITANCE](#) tax, which is a tax levied on individuals receiving property from the estate. Gift tax laws have been enacted to prevent tax avoidance by [TRANSFER OF ASSETS](#) as gifts prior to death. Federal Estate Tax laws are integrated with Federal Gift tax laws so that it is more difficult to shield large estates from taxation. A number of individual states also have enacted an estate tax law.

Although the taxation of gifts and estates may seem complex, the calculation of estate and gift taxes is similar to the calculation of personal income taxes. As with the [INCOME TAX](#), there are exemptions and credits that are applied before the progressive rate schedule is applied. Estate taxes are different in that they are calculated over a lifetime, rather than year by year.

Gift Tax

Gift tax applies to the transfer by gift of any property, including money or the use of or income from property. The sale of an asset for less than its full value or the lending of money at interest-free or reduced interest rates, may also constitute a gift for tax purposes. Although any gift has the potential to be taxable, there are a number of exemptions.

There is an annual exclusion of the first \$10,000 given to any one person during a calendar year. There is an educational and medical expense exclusion. Gifts to a spouse, a political organization, or charities are not subject to gift tax.

Annual Exclusion

A separate \$10,000 annual exclusion applies to each person to whom a gift is made. A person can give up to \$10,000 each to any number of people each year and none of the gifts will be taxable. Married people can separately give up to \$10,000 to the same person each year without making a taxable gift.

Gift Splitting

If a married couple makes a gift to a third party, the gift can be considered as made one-half by each person. This is known as gift splitting. Both spouses must agree to split the gift. Gift splitting allows a married couple to give up to \$20,000 to a person annually without making a taxable gift. If a gift is split, the couple should file a gift [TAX RETURN](#) proving the agreement to split the gift existed. This is true even where half of the split gift is less than \$10,000. The **IRS** provides a shorter form for this purpose, Form 709-A.

Unified Credit

Most gifts above the annual exemption are still not subject to tax because each taxpayer is allowed a lifetime credit against taxable gifts and estate. A credit is generally an amount which reduces the amount of taxes owed. A unified credit applies to both the gift tax and the estate tax. The unified credit can be subtracted from any gift owed by the taxpayer. Unified credit used against a gift tax in one year reduces the amount of credit that can be applied in later years. The total amount used against a gift tax reduces the credit available to use against estate tax. Any unified credit not used against gift tax during the taxpayer's lifetime is available for use against the estate tax.

Previously, the unified credit was \$220,550, which eliminated taxes on a total of \$675,000 of taxable gifts and taxable estate. These amounts were increased for gifts made and for estates of decedents dying after 2001. For 2002 and 2003, the unified credit is \$229,800 on a total of \$700,000. In 2004, it goes to \$287,300 on \$850,000. In 2005, it rises to \$326,300 on \$950,000. After 2005, the amount becomes \$345,800 on a million dollars.

Gift Tax Return

A gift tax return is filed with annual income taxes on Form 709. This form is required for gifts of over \$10,000 to someone other than a spouse, a married couple splitting a gift (although they may be able to file the shorter form, Form 709-A). A gift tax return is not required for gifts to political organizations and gifts made by paying tuition or medical expenses. A gift tax return is not required for gifts made to charities or for a qualified conservation [EASEMENT](#).

Estate Tax

A person's taxable estate is defined as the gross estate less allowable deductions. Gross estate means the value of all property in which the decedent had an interest at the time of death. The gross estate would also include life insurance proceeds payable to the estate or the heirs, the value of certain annuities payable to the estate or heirs, and the value of certain property transferred three years or less prior to death. Estate taxes are due to the IRS nine months from the date of death.

Taxable Estate

The taxable estate includes the value of all property and assets owned at the time of death plus any gifts made in the three years prior to death. Allowable deductions from a decedent's taxable estate include funeral expenses, debts the decedent owed at the time of death, the marital [DEDUCTION](#), and costs of administering and settling the estate. Any unified credit not used to eliminate gift tax can be used to eliminate or reduce estate tax. Currently, although the first \$675,000 of an entire estate is excluded from taxation, estates with values above that have federal estate-tax rates which range from 37 percent to 55 percent.

Recipients

The person who receives a gift or an estate does not have to pay any gift tax or estate tax because of it. (Estate tax is considered to be payable by the estate itself rather than the heirs.) Additionally gifts and inheritances are not subject to income tax.

1997 Taxpayer Relief Act

Until 1997, every taxpayer was allowed a lifetime credit against estate and gift taxes of \$192,800. This was equivalent to a \$600,000 exemption from estate and gift taxes. This meant that taxpayers who gave no taxable gifts during the course of their lives would pay no tax on the first \$600,000 of their taxable estate. The 1997 Act raised the amount of the unified credit gradually over nine years. The Estate Tax Applicable Exclusion Amount increases over the next several years until it reaches \$3.5 million in 2009.

Unlike the estate tax, the gift tax is not repealed in 2010, and there is a separate applicable exclusion amount for gift tax purposes which is not the same as the one for estate tax purposes. The gift tax exclusion amount will increase to \$1 million in 2002 and remain there. From 2002 through 2009, the top marginal estate tax and gift tax rates are the same. For 2010, gifts in excess of the \$1 million exclusion amount are subject to a gift tax at a rate which will be equal to the top individual income tax rate at that time.

Even before 1997, an individual always gave a total of \$10,000 (\$20,000 for married joint filers) per recipient in gifts each year without incurring any tax. But since this amount was not indexed for inflation, the real value of the \$10,000 exclusion had been falling since 1976, when the \$10,000 amount was set. The Taxpayer Relief Act indexes the \$10,000 exclusion to the rate of inflation.

Economic Growth and Tax Relief Reconciliation Act of 2001

Beginning in 2002 and through 2009, the top federal estate and gift tax rates will be reduced. The rate drops from 55% to 50% in 2002, and then by one percentage point annually until reaching 45% in 2007. Finally, the federal estate tax will be completely eliminated in 2010. The law also substantially increases the amount that individuals can pass to their heirs free of federal estate taxes to \$1 million in 2002 and gradually to \$3.5 million in 2009. Full [REPEAL](#) follows in 2010. However, the law has a "sunset" provision which means that if Congress passes no additional law, the estate tax laws in effect prior to the Tax Relief Act of 2001 would be reinstated in 2011. Gift tax rates will be reduced on the same schedule as the estate tax rate. However, when the estate tax is repealed in 2010, taxpayers will still be subject to a lifetime gift tax, with a maximum gift tax rate of 35%, which is the same as the maximum income tax rate. Gift tax rates will be reduced on the same schedule as the estate tax rate. The GST tax will be repealed for all transfers after December 31, 2009.

Generation-skipping Transfer Tax

Generation-skipping [TRANSFER TAX](#) (GST) applies in the event a person omits their own children as beneficiaries and instead leaves the inheritance directly to their grandchildren, the tax is calculated at a flat rate of 55 percent. This is in addition to estate taxes, which can also be as high as 55 percent. There is, however, a \$1,000,000 GST tax exemption, which may be used during the taxpayer's, life or at death. Married couples have a \$1,000,000 exemption each. Certain educational and medical expenses are excluded and gifts that qualify for the \$10,000 gift tax exclusion can avoid the GST tax.

State Taxes

Many states have some form of estate or inheritance taxes. A state death-tax credit is available when computing federal estate taxes, but it is limited. State taxes vary widely from state to state. Some, including Alaska, Florida, Nevada, and New Mexico, have no estate tax. Some states tax the entire estate, some only the portions passed on to beneficiaries, and some take part of the federal estate tax credit.

ARIZONA: The Arizona estate tax is on the transfer of property or interest in property. This tax is assessed against the [NET](#) estate before it is distributed. Arizona estate tax is imposed on the Arizona estate of both resident and nonresident decedents. Arizona does not impose an inheritance or gift tax.

COLORADO: The Colorado estate tax replaced the Colorado inheritance tax for decedents with a date of death on or after Jan.1, 1980. The Colorado gift tax does not apply to transfers made on or after Jan. 1, 1980. A Colorado Estate Tax Return must be filed only if a United States Estate Tax Return is required to be filed. Colorado has a generation-skipping transfer tax. Colorado estate tax is based on the state death tax credit allowable on the federal return. Colorado has no separate extension provisions for filing or for paying of estate tax but does honor extensions approved by the IRS.

FLORIDA: Florida's estate tax system is commonly referred to as a "pick up" tax. Florida picks up all or a portion of the credit for state death taxes allowed by the federal government. Under this system, Florida estate tax is not due unless an estate is required to file a federal estate tax return.

LOUISIANA: Louisiana imposes an inheritance tax and an estate transfer tax. According to the law of this state, the inheritance tax is a tax imposed upon the heirs of a decedent for the privilege of receiving property from the deceased. Estate transfer tax is designed to absorb the federal state death tax credit allowable under the Internal Revenue Code. The estate transfer tax does not impose any additional tax burden on the decedent's estate but merely shifts payment from the federal government to the state.

NEW YORK: New York has an estate tax, but for estates of individuals deceased on or after February 1, 2000, it has revised the method of calculating the tax. Estates are only required to file a New York State estate tax return if the estate is also required to file a federal estate tax return. The filing requirements for New York State are identical to the federal requirements for dates of death through 2003. The additional federal increases in the filing threshold beyond 2003 are not incorporated in New York State Tax Law, so the filing threshold for New York State remains at one million dollars. Beginning with dates of death in 2004, some estates will have to file a New York State estate tax return even if they are not required to file a federal estate tax return. New York State estate tax conforms to the federal Internal Revenue Code of 1986 with all amendments enacted on or before July 22, 1998, but does not provide for the decreases in the federal credit for state death taxes that are applicable to dates of death after 2001. As a result, estates of individuals with dates of death after 2001 that pay a New York State estate tax will not receive full credit on the federal estate tax return for the tax paid to New York State. New York State Gift Tax was repealed as of January 1, 2000.

Additional Resources

Rethinking Estate and Gift Taxation. Slemrod, James, Brookings Institution Press, 2001.

Organizations

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