

GIFT AND ESTATE TAXES

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If you give away money or property during your life, those transfers may be subject to federal gift tax and perhaps state gift tax. The money and property you own when you die (i.e., your estate) may also be subject to federal estate taxes and some form of state death tax. You should understand these taxes and when they do and do not apply, especially since the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act) signed by President Bush on June 7, 2001. This law contains several changes (some of which are retroactive) that are complicated and uncertain, making estate planning all the more difficult.

Federal gift tax and federal estate tax—background

Under pre-2001 Tax Act law, no gift tax or estate taxes were imposed on the first \$675,000 of combined transfers (those made during life and those made at death). The tax rate tables were unified into one—that is, the same rates applied to gifts made and property owned by persons who died in 2001. Like income tax rates, gift and estate tax rates were graduated. Under this unified system, the recipient of a lifetime gift received a carryover basis in the property received, while the recipient of a bequest, or gift made at death, got a step-up in basis (usually fair market value on the date of death of the person who made the bequest or gift).

The law substantially changed this tax regime.

Federal gift tax

The 2001 Tax Act increased the applicable exclusion amount for gift tax purposes to \$1 million for 2002 and each year thereafter (even though the applicable exclusion amount for estate tax purposes increases in years 2004 through 2009). The top gift tax rate is 48 percent in 2004, 47 percent in 2005, 46 percent in 2006, 45 percent in 2007 through 2009, and 35 percent in 2010 (the top marginal income tax rate in 2010 under the 2001 Tax Act). In 2011, the gift tax rates revert to pre-2001 Tax Act levels. The carryover basis rules remain in effect.

However, under the new law, many gifts can still be made tax free, including:

- Gifts to your U.S. citizen spouse (you may give up to \$114,000 in 2004 tax free to your noncitizen spouse)
- Gifts to qualified charities
- Gifts totaling up to \$11,000 to any one person or entity during the tax year, or \$22,000 if the gift is made by both you and your spouse (and you are both U.S. citizens)
- Amounts paid on behalf of any individual as tuition to an educational organization or to any person who provides medical care for an individual

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State gift tax may also be owed if you are a resident of Connecticut, Louisiana, North Carolina, Tennessee, or Puerto Rico.

Federal estate tax

Under the 2001 Tax Act, the applicable exclusion amount for estate tax purposes increases in steps until it reaches \$3.5 million in 2009 (the applicable exclusion amount for gift tax purposes remains fixed at \$1 million). Top estate tax rates are 48 percent in 2004, 47 percent in 2005, 46 percent in 2006, and 45 percent in 2007 through 2009. The estate tax (but not the gift tax) is repealed in 2010, but the estate tax applicable exclusion amount and rates revert to pre-2001 Tax Act levels in 2011.

When the estate tax is repealed in 2010, the basis rules will be changed to those similar to the gift tax basis rules. The step-up in basis rules return in 2011.

Many of the estate tax deductions remain in effect, and some have even been improved, but the qualified family-owned business deduction has been eliminated for persons dying after 2003.

Note: For estates that have previously elected the qualified family-owned business deduction, the recapture rules continue to remain in effect until the 10-year recapture period has expired.

Federal generation-skipping transfer tax

The federal generation-skipping transfer tax (GSTT) taxes transfers of property you make, either during life or at death, to someone who is more than one generation below you, such as a grandchild. The GSTT is imposed in addition to, not instead of, federal gift tax or federal estate tax. You need to be aware of the GSTT if you make cumulative generation-skipping transfers in excess of the GSTT exemption, which is \$1.5 million (in 2004 and 2005). A flat tax equal to the highest estate tax bracket in effect in the year you make the transfer is imposed on every transfer you make after your exemption has been exhausted.

Some states also impose their own GSTT.

Note: Starting in 2004, the GSTT exemption is the same amount as the applicable exclusion amount for estate tax purposes.

State death taxes

The three types of state death taxes are estate tax, inheritance tax, and credit estate tax, which is also known as a sponge tax or pickup tax. The estate and inheritance taxes are known as basic taxes, and some states impose one of the two. All states impose the credit estate tax, either alone or in addition to a basic tax.

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Final Page - Disclaimer

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