

## **Gift and Estate Tax Computational Problem**

### **¶ 2013**

#### **1998 Gift of \$60,000:**

2501(a) imposes the gift tax, but 2502 provides the computation.

Step 1: 2502(a)(1) tentative tax on current year gifts PLUS gifts for preceding calendar year periods, back to June 6, 1932. See 2502(b).

Tax on \$60,000 would be \$13,000.

Step 2: 2502(a)(2), subtract a tentative tax on the prior year gifts. Because they are -0-, this tax is zero, so the net tax before credits is \$13,000.

You can't tell from your Code what the gift tax credit was in 1998, but it exceeded \$13,000, so we owe nothing, but our available 2505 credit is reduced.

#### **1999 Gift of \$40,000:**

Step 1: 2502(a)(1) tentative tax on cumulative gifts of \$100,000. That is \$23,800.

Step 2: 2502(a)(2), subtract a tentative tax on the prior year gifts. That is \$13,000, yielding a net tax before credits of \$10,800.

Again, the 2505 credit in 1999 of \$211,300 (minus the \$13,000 already used) absorbs this, so no tax due.

#### **2000 Gift of \$700,000:**

Step 1: 2502(a)(1) tentative tax on cumulative gifts of \$800,000. That is \$267,800.

Step 2: 2502(a)(2), subtract a tentative tax on the prior year gifts. That is \$23,800, yielding a net tax before credits of \$244,000. The unified credit for 2000 under 2505 was \$220,550, and we already used \$23,800 in prior years, leaving \$196,750 for this year. Consequently, we need to send a check by April 15, 2001 (the gift tax return is due when the individual tax return is due) of \$47,250.

Had the taxpayer waited a few years for the unified credit to increase, she could have avoided paying all gift taxes. Indeed, today one can gift an aggregate \$1,000,000 free of gift tax.

#### **2006 Estate Tax:**

We need to shift to 2001(a) for the estate tax computation.

Step 1: A tentative tax on the sum of the taxable estate and adjusted taxable gifts (defined by the flush language of 2001(b) as only gifts after 1976—i.e., we don't go back to 1932).

This is a tax on the \$2,500,000 estate plus the \$800,000 of gifts, \$3,300,000, yielding a tentative tax of \$1,378,800 (note the 2001(c)(2) cap on the maximum rate, modifying the tax rate schedule).

Step 2: We subtract the tax that would have been payable on taxable gifts after 1976 using current rates. The trick here is the “payable” term; that is interpreted as after credits. The tentative tax on \$800,000 of gifts would be \$267,800, the same amount as above in the gift tax computation, minus the credits we took at that time of \$220,550, yields the \$47,250 check we sent in 2001.

Taking the \$1,378,800 of estate tax, and reducing that by the \$47,250 of gift taxes already paid, gives us a net estate tax before credits of \$1,331,550. Pay me now or pay me later, the essence of unification.

In 2006 (as well as in 2007 and 2008) the amount you could pass, free of tax, was \$2,000,000. However, we need to convert that to a credit. Under the tables, the tax on \$2,000,000 would be \$780,800 so that is our applicable credit amount.  $\$1,331,550 - \$780,800 = \$550,750$ , net estate tax due, and it is due 9 months after date of death.

### **Observations:**

1. With the benefit of hindsight, it was a mistake to incur a gift tax back in 2000, when we could have made gifts in excess of that amount free of tax later. The cost to us is the time value of money, as we did receive a credit for those taxes in the estate tax computation under 2001(b)(2). However, if we gifted some asset that would explode in value, that still might have worked out in avoiding wealth transfer taxes. Imagine that the asset was pre-IPO stock that increased 20-fold after the gift. Also, considering the current hot art market, this could have been the gift of a painting that would explode in value a few years later. Or land next to a new highway. . .and so forth. Also, the actual payment of the gift taxes, the cash, is gone so we don't pay any estate taxes on that cash. Recognize that the cash and other assets owned by the decedent at death are taxable. . .and then 45% of those assets are mailed to the IRS. This is the “tax exclusivity” of the gift tax as compared with the “tax inclusivity” of the estate tax. Section 2035 adds back gift taxes paid within 3 years of death, but we don't fall into that rule.
2. Students at first blush believe that you receive two unified credits, one under 2505 and one under 2010, because the 2010 credit is not reduced (by its own terms) by lifetime uses of the credit. Read 2010 again and compare it to the language of 2505. However, the 2001 computation recaptures that through adding back the adjusted taxable gifts in the tax computation under 2001(b)(1), and then permitting an offsetting deduction under 2001(b)(2) only to the extent that the taxpayer sent a check. So, to the extent no gift taxes were payable due to prior

uses of the credit, the estate in essence gives back the lifetime uses of the unified credit in the 2001(b)(2) computation.

3. With the EGTRRA de-unification of the unified credit, where one in 2007 can pass away with an estate of \$2,000,000 and pay no estate tax, yet gifts in excess of \$1,000,000 are taxed, one would almost never make a taxable gift these days. Plus, if the taxes are repealed (or the exemptions increased so much that the taxpayer is exempt), where would the taxpayer be? EGTRRA consequently places more importance on testamentary transfers as opposed to lifetime transfers. But, that said, if the taxpayer uses the annual gift exclusion, valuation discounts, GRATs, etc., there still is a lot of planning that involves making gifts of exploding assets (e.g., the IPO stock) or simply maximizing the \$12,000 per person annual exclusion (that saves one \$5,400 in estate tax for each of those gifts, @45%), or using the lifetime \$1,000,000 for appreciating assets. Life insurance can be an “exploding asset” and we can often transfer that value free of gift tax through the use of the Crummey trust that we will study later.