The Federal Gift and Estate Tax Structure

University of Tennessee Agricultural Experiment Station

R. W. Todd

Follow this and additional works at: http://trace.tennessee.edu/utk_agbulletin

Part of the Agriculture Commons

Recommended Citation
http://trace.tennessee.edu/utk_agbulletin/392

The publications in this collection represent the historical publishing record of the UT Agricultural Experiment Station and do not necessarily reflect current scientific knowledge or recommendations. Current information about UT Ag Research can be found at the UT Ag Research website. This Bulletin is brought to you for free and open access by the AgResearch at Trace: Tennessee Research and Creative Exchange. It has been accepted for inclusion in Bulletins by an authorized administrator of Trace: Tennessee Research and Creative Exchange. For more information, please contact trace@utk.edu.
The Federal Gift and Estate Tax Structure

R. W. Todd

The University of Tennessee
Agricultural Experiment Station
Knoxville, Tennessee
D. M. Gossett, Dean
LIMITATION

The federal estate and gift tax structure is relatively complex. Additionally, statutes are changed fairly often, and their application may change from time to time due to litigation and administrative regulations. This publication can be helpful in better understanding estate and gift tax law and can help facilitate communication with estate planning counselors. This publication should not be used as a guide to planning a particular estate or establishing a lifetime giving plan. An attorney who is experienced in estate and gift taxation should be consulted for advice and to prepare necessary technical documents when an estate plan is considered.
**TABLE OF CONTENTS**

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. The Federal Gift Tax Structure</strong></td>
<td></td>
</tr>
<tr>
<td>Transfers Having Gift Status</td>
<td>5</td>
</tr>
<tr>
<td>Transfers in General</td>
<td>6</td>
</tr>
<tr>
<td>Powers of Appointment</td>
<td>6</td>
</tr>
<tr>
<td>Tenancy by the Entirety</td>
<td>7</td>
</tr>
<tr>
<td>Property Settlements</td>
<td>7</td>
</tr>
<tr>
<td>Annuities</td>
<td>8</td>
</tr>
<tr>
<td>Disclaimers</td>
<td>8</td>
</tr>
<tr>
<td>Valuation of Gifts</td>
<td>9</td>
</tr>
<tr>
<td>Adjustment for Split Gifts</td>
<td>10</td>
</tr>
<tr>
<td>Exclusions and Deductions</td>
<td>10</td>
</tr>
<tr>
<td>Annual Gift Tax Exclusion</td>
<td>11</td>
</tr>
<tr>
<td>Charitable Deductions</td>
<td>12</td>
</tr>
<tr>
<td>Marital Deduction</td>
<td>12</td>
</tr>
<tr>
<td>Determining Gift Taxes Due</td>
<td>12</td>
</tr>
<tr>
<td>Combining Previous and Current Period Gifts</td>
<td>13</td>
</tr>
<tr>
<td>The Unified Tax Table</td>
<td>13</td>
</tr>
<tr>
<td>Payment of Gift Taxes</td>
<td>13</td>
</tr>
<tr>
<td>The Unified Credit</td>
<td>13</td>
</tr>
<tr>
<td>Payment of Gift Tax</td>
<td>16</td>
</tr>
<tr>
<td><strong>II. The Federal Estate Tax Structure</strong></td>
<td>16</td>
</tr>
<tr>
<td>The Gross Estate</td>
<td>16</td>
</tr>
<tr>
<td>Dower and Curtesy Interests</td>
<td>16</td>
</tr>
<tr>
<td>Gifts Within Three Years of Death</td>
<td>17</td>
</tr>
<tr>
<td>Retained Life Interest</td>
<td>18</td>
</tr>
<tr>
<td>Transfers Effected by Decedent’s Death</td>
<td>18</td>
</tr>
<tr>
<td>Revocable Transfers</td>
<td>18</td>
</tr>
<tr>
<td>Annuities</td>
<td>19</td>
</tr>
<tr>
<td>Joint Interests</td>
<td>19</td>
</tr>
<tr>
<td>Powers of Appointment</td>
<td>20</td>
</tr>
<tr>
<td>Life Insurance Proceeds</td>
<td>20</td>
</tr>
<tr>
<td>Disclaimers</td>
<td>20</td>
</tr>
<tr>
<td>Valuation of Assets Includible in the Gross Estate</td>
<td>20</td>
</tr>
<tr>
<td>Adjustments to the Gross Estate</td>
<td>21</td>
</tr>
<tr>
<td>Expenses, Debts, Taxes</td>
<td>21</td>
</tr>
<tr>
<td>Casualty and Theft Losses</td>
<td>22</td>
</tr>
<tr>
<td>Charitable Transfers</td>
<td>22</td>
</tr>
<tr>
<td>Marital Deduction</td>
<td>22</td>
</tr>
<tr>
<td>Orphans Exclusion</td>
<td>23</td>
</tr>
</tbody>
</table>
The Federal Gift and Estate Tax Structure

R. W. Todd*

INTRODUCTION

The laws affecting federal estate and gift taxation have changed substantially during the last decade. The first sweeping change was ushered in by the Tax Reform Act of 1976.¹ That act affected changes constituting a major overhaul of the federal estate and gift tax law by combining the two taxes into a unified scheme. Changes since 1976 have occurred often and generally have modified exemptions, deductions, or rates, leaving the basic structure intact. The Economic Recovery Tax Act of 1981² greatly reduced the burdens from estate and gift taxation. Major changes incorporated by the 1981 Act are outlined in this report.

For adequate estate and gift tax planning, some knowledge of the taxing mechanism as well as competent counsel are important. The purpose of this report is to outline the federal gift and estate tax structure after changes incorporated by the Economic Recovery Tax Act of 1981.

THE FEDERAL GIFT TAX STRUCTURE

Lifetime gifts can be one of the more important planning devices available in reducing inheritance and estate taxes and probate and estate settlement costs. In addition to potential savings of estate assets, other goals of estate planning are often facilitated by the use of gifts. In order to effectively utilize gifts in estate planning, some knowledge of the federal gift tax laws is necessary. Although the federal estate and gift tax laws have been combined into a unified

*Associate Professor, Department of Agricultural Economics and Rural Sociology, University of Tennessee, Knoxville.


²Pub. Law, 97-34, August, 1981.
scheme, the gift tax laws can in many respects be examined as a separate set of rules.

Transfers Having Gift Status

A gift is a voluntary transfer of property or an interest in property from the donor (person making the gift) to the donee (recipient of the gift) without any compensation received in return. Some of the conditions for a completed gift are: 1) the donor should possess contractual capacity (mental capacity and 18 years of age or majority) and donative intent; 2) actual delivery of the property (or title, bill of sale, etc.); and 3) be accepted by the donee. For income tax purposes a transfer of property is generally considered a gift if it is made unconditionally from a “detached and disinterested generosity” out of respect, affection or charity and without any moral or legal duty and without expected economic benefits. However, the definition of gifts for income tax purposes and gifts in the gift and estate tax context are not necessarily synonymous. For example, a proposed gift might be taxable as income to the donee (not a gift) but taxable to the donor as a gift.

Prior to the Economic Recovery Tax Act of 1981 there were six specific sections of the Internal Revenue Code that identified as gifts various types of property transfer. Each of the six categories of property transfer having gift status will be discussed briefly. Five of the six types of property transfer having gift status are still in effect. Persons involved with some of these transactions might not think of them as gifts in the absence of a general knowledge of the gift tax laws.

Transfers in General

The gift tax is made applicable to transfers of property or interests in property whether “in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.” Nonresidents who are not citizens of the United States are taxed on gifts of tangible property situated in the United States. In a few instances gifts made by nonresidents who are not citizens of the United States are taxed on gifts of intangible property deemed by law to be situated within the U. S.

---


4 I. R. C., § 2511.
Powers of Appointment

A power of appointment consists of the right of the person possessing the power to appoint, select or determine the recipient of specified property or the income therefrom. The person possessing the power does not have title to the property but acts as a conduit through which title flows. There are two types of such power. First, a general power of appointment is “a power which is exercisable in favor of the individual possessing the power . . . , his estate, his creditors, or the creditors of his estate”\(^5\) (excepted, however, are certain powers to consume for health, education, support, or maintenance of the person possessing the power and certain other powers created before October 21, 1942). A special power of appointment restricts potential appointees to a group or class specified in the instrument creating the power and does not generally include the person possessing the power of appointment.

The possessor of a general power of appointment is considered to have made a gift upon the exercise of the power and will be subject to the gift tax laws as if his own property had been given.\(^6\) In the alternative, if the possessor of a general power of appointment fails to exercise his power or if he should give up or release the power he is not deemed to have made a gift under the gift tax laws. The exercise of rights under a special power of appointment does not take on gift status under federal law.

As an example of a general power of appointment, assume that Able Farmer died leaving a large number of shares of General Motors stock. In his will Able specified that income from the stock would go to his wife and that she should have a general power to appoint the persons or charities that should take title to the property at her discretion. Able’s wife could appoint herself to take title to the stock or she could designate that it be part of her estate at her death or she could designate any other person or charity to receive the stocks. If she designates the recipient of the stock she is considered to have made a gift which is subject to gift taxation. If she never designates the recipient or if she gives up her power to so designate, she is not considered to have made a gift.

Tenancy by the Entirety

Provisions in the gift tax laws in effect prior to January 1, 1982, contained two special rules governing the treatment of jointly held property. First, where a husband and wife had taken ownership of

\(^5\) I. R. C., § 2514(C).

\(^6\) I. R. C., § 2514(a).
real property as tenants by the entirety and one of them furnished all or a major part of the purchase money, they could elect to have the transfer considered a gift and pay a gift tax; or if such election was not exercised, then a gift was effective between the spouses when the tenancy terminated. Second, where a joint interest with right of survivorship was created by a husband and wife in personal property after December 31, 1976, the assumption was made that each spouse owns half of the joint interest for gift computation purposes. To be consistent with increases in the marital deductions provided in the Economic Recovery Tax Act of 1981, these provisions have been removed from the IRS Code with the result that transfers made between marital partners after December 31, 1981, will not be subject to gift taxation.

**Property Settlements**

Property settlements involving separation and divorce are sometimes partially treated as gifts. Where a written agreement is entered between marital partners relative to their property and marital rights and divorce occurs within two years thereafter, any transfer of property interests made pursuant to the agreement in settlement of marital or property rights or as reasonable child support are not gifts for gift tax purposes.

**Annuities**

Where an employer provides a plan through which an employee acquires an unqualified right to an annuity, but elects a smaller annuity with a provision that after his death a survivor annuity will be paid, a transfer is made under the “Transfers in General” section (§2511) of the Internal Revenue Code. The transfer or gift is considered to be made by the employee at such time that he gives up the power to deprive the beneficiary of the survivor annuity or payment. Thus, the employee must in some ways irrevocably elect to take a reduced payment and designate the beneficiary of the survivor annuity for the transaction to be considered a gift. Otherwise, the transfer would be made at death and the estate tax laws rather than gift tax laws would be applicable.

71. R. C., §2515. (Repealed Pub. Law 97-34, Title IV, §403 (c) (3) (B), August 13, 1981.)  
8I. R. C., §2515(A). (Repealed Pub. Law 97-34, Title IV, §403 (c) (3) (B), August 13, 1981.)  
10I. R. C., §2516.
Many would-be transfers for gift tax purposes are rendered non-transfers under another section of the IRS Code if qualified plans are adopted by the employer and the employee properly gives up the right to change the beneficiary of the survivor annuity.\footnote{1. R. C., § 2517.} Under this section only the proportionate part of the survivor annuity that resulted from contributions made by the employee are considered a gift and are subject to gift taxes.\footnote{12It should be noted that such transfers are always considered future interests and do not qualify for the annual exclusion discussed in a following section of this paper.}

**Disclaimers**

Under the gift tax laws a person may make a qualified disclaimer with respect to property or an interest in property that otherwise would have been transferred to him without gift tax consequences. A disclaimer is an irrevocable and unqualified written refusal by a proposed recipient of property or a property interest before acceptance of the interest or any of its benefits. To constitute a qualified disclaimer the written refusal generally must be received by the person transferring the interest or his legal representative within nine months of the day on which the transfer creating the interest is made; and as result of such refusal, the interest must pass without any direction by the disclaimant to the spouse of the person transferring the interest or to another person other than the disclaimant. Prior to passage of the Economic Recovery Tax Act, an attempted disclaimer that was not effective under state law resulted in a transfer for which gift tax consequences attached. The new provision removes the need for validity under state law if federal requirements are otherwise met.\footnote{13I. R. C., § 2518 (c) (3). (Supp. 1982—As amended Pub. Law 97-34, Title IV, § 426 (a), August 13, 1981.)}

**Valuation of Gifts**

Generally, the amount or value of a gift of property is the fair market value of the property at the time of the gift.\footnote{14I. R. C., § 2512.} Fair market value is the "price at which the subject property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts."\footnote{15Treas. Reg. § 25.2512-1.} Fair market value is most often determined by an
appraisal by a qualified person who is familiar with the local market conditions where the property is located and would likely be sold. Fair market value of stocks and bonds is generally determined by taking the mean between the highest and lowest selling price on the valuation date.\textsuperscript{16} Notes are assumed to have a fair market value equal to the unpaid principal plus accrued interest to the valuation date. If notes are valued at less than face amount plus accrued interest, satisfactory evidence must be submitted showing why the lower amount represents fair market value of the note.

Sometimes property is sold for less than fair market value, especially in interfamily transactions. In such cases the amounts by which market value exceeds the consideration paid for the property is treated as a gift whether or not the seller intended to make a gift.\textsuperscript{17}

Adjustment for Split Gifts

The gift tax laws provide for gift splitting for gifts made to third parties by a married couple when only one of them owns property.\textsuperscript{18} A precondition for the gift splitting provision to apply is that each spouse must be a citizen or resident of the United States. In addition, both parties must consent to the gift. Such consent may be signified on a gift tax return filed within a specified period of time which generally ends on the 15th day of the second month following the close of the filing period\textsuperscript{19} in which the transfer was made.\textsuperscript{20}

Under the gift splitting provisions, a married person who owns property can effectively transfer property by gift as if the spouse owned half interest. The gift tax liability for such gifts becomes a joint and several liability of each spouse. Where a joint and several liability attaches either spouse individually or the two jointly may be required to pay the entire gift tax associated with the split gift.

Exclusions and Deductions

Limited gifts to individuals and unlimited gifts to spouses and qualified charities are not included in transfers for purposes of determining gift taxes. Prior to the Economic Recovery Tax Act of 1981, unlimited gifts to a spouse were not deductible.

\textsuperscript{16}Treas. Reg. §§ 25.25122 (b).

\textsuperscript{17}I. R. C., § 2512 (b).

\textsuperscript{18}I. R. C., § 2513.

\textsuperscript{19}The filing period has changed over time as follows: 1932 to 1970 inclusive the filing period was the calendar year; 1971 to 1981 inclusive—the calendar quarter; 1982 and thereafter—the calendar year.

\textsuperscript{20}Treas. Reg. § 25.2513-2.
Annual Gift Tax Exclusion

The Economic Recovery Tax Act of 1981 increased the annual gift tax exclusion from $3,000 to $10,000 per donee effective for transfers occurring after December 31, 1981, and provided an unlimited exclusion for transfers involving payment of certain medical and tuition expenses. Where tuition expenses are paid to an approved educational institution on behalf of an individual or where medical expenses are paid on behalf of an individual, such payments are not considered transfers for gift tax purposes. To qualify for the annual gift tax exclusion the property or property interest transferred must be a "present interest" as distinguished from a "future interest." For gift tax purposes a "future interest" is an interest in property which is limited to commence in use, possession, or enjoyment at some future date or time. Normally gifts to minors are considered to be future interests unless care is taken to select a custodian other than the donor and meet the conditions of the uniform gifts to Minors Act or to make the gift in trust with the donor relinquishing all rights to influence the distribution or enjoyment of the trust property.

Through use of the annual gift tax exclusion a property owner may transfer by gift the annual exclusion to as many donees as he may wish. After December 31, 1981, a property owner may give up to $10,000 each to any number of people annually without any gift tax liability; and if married and the spouse will join in making split gifts, the annual exclusion can effectively be increased to $20,000 per donee. The annual gift tax exclusion applies so long as gifts to an individual do not exceed the exclusion amount. Where the exclusion amount is exceeded, a gift tax return must be filed. Interspousal gifts and qualifying gifts involving payment of tuition or medical expenses that surpass the annual exclusion amount do not require a gift tax return.

Prior to the Economic Recovery Tax Act of 1981, the Internal Revenue Code provided that payments made into a qualifying individual retirement account on behalf of a spouse would not be considered a gift of a future interest in property. The new law repealed

---


the applicable subsection of the code.\footnote{I. R. C., § 2503 (d). (Repealed Pub. Law 97-34, Title III, §311 (h) (5), August 13, 1981.)} The result is that such transfers will no longer qualify for the annual gift tax exclusion.

**Charitable Deductions**

Contributions of property to authorized charities are generally excludable from taxable gifts and no gift tax is due thereon. Authorized charities included governmental units and a variety of private charities "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes."\footnote{I. R. C., § 2522 (a) (b).} Restrictions on such organizations prohibit: 1) any part of net earnings to accrue to the benefit of a private shareholder or individual; 2) any substantial part of its activities directed to disseminating propaganda, or otherwise attempting to influence legislation; and 3) participation in or intervention in any political campaign on behalf of any candidate for public office.\footnote{I. R. C., § 2522 (c); Treas. Reg. 25.2522 (a)-1.}

**Marital Deduction**

Prior gift tax law permitted deducting all outright lifetime gifts of property between spouses for the first $100,000 and half of such gifts made above $200,000.\footnote{Pub. Law 94-455, Title XIX, § 1902 (a) (12) (E), Title XX, § 2002 (b), October 4, 1976. Prior to the Tax Reform Act of 1976, the gift tax deduction was half of all lifetime gifts between married persons.} The Economic Recovery Tax Act of 1981 permits unlimited interspousal gifts free of gift tax or gift tax filing requirements for gifts made after December 31, 1981. However, all gifts made between spouses within three years of the donor's death (except for gifts that qualify for the annual exclusion) will be included in the decedent's gross estate.\footnote{Pub. Law 97-34, Title IV, Subtitle A, § 403 (b) (effective January 1, 1982).}

**Determining Gift Taxes Due**

The gift tax laws place the burden of paying the tax upon the donor rather than the recipient of the property.\footnote{I. R. C., § 2502 (d).} Gift tax returns must be filed soon after the end of the filing period in which reportable gifts are made. After proper categorization, valuation and summation of gifts for a filing period and adjustments for split gifts, exclusions and deductions have been made, several additional steps are necessary in meeting all of the criteria of the gift tax laws.
Combining Previous and Current Period Gifts

Gifts for the filing period for which the return is being prepared must be added to all previous lifetime taxable gifts before the tax on current gifts can be determined. This determination is necessary because the tax rate applies cumulatively and is progressive. This cumulativeness of progressiveness means that as more and more gifts are made over time, higher gift tax rates will apply until the maximum rate is reached.

The Unified Tax Table

Beginning in January, 1977, the tax rates for both gift and estate taxes were unified in one schedule.31 The rates beginning on that date range from 18 to 70 percent of the taxable gifts or taxable estate as the case may be. These rates are scheduled to be reduced to a maximum of 50 percent as result of the Economic Recovery Tax Act of 1981 (Table 1).32 The 50 percent maximum rate will not be effective immediately but is subject to a phase-in schedule that reduces the maximum gift tax rate to 65 percent for gifts made in 1982; to 60 percent for gifts made in 1983; to 55 percent for gifts made in 1984; and to 50 percent for gifts made in 1985 and thereafter.

Payment of Gift Taxes

After combining the amount of taxable gifts for the current period with taxable gifts from previous periods, the tentative tax is read directly from the unified tax table (Table 1).33 From the tentative tax a credit is allowed for all gift tax paid in previous periods.

The Unified Credit

A credit provided that can be used to offset any tax due on lifetime gifts and any part of the credit unused for offsetting gift taxes is applied to offset estate taxes. The unified credit first appeared in the gift and estate tax laws as part of the Tax Reform Act of 1976. Its purpose was to offset the effect of exemptions allowed under prior law including a $30,000 lifetime gift tax exemption and a $60,000 estate tax exemption, each of which was being eliminated in the same legislation that provided for the unified credit. The unified

---

31This was one of many changes in the federal estate and gift tax laws contained in the Tax Reform Act of 1976.
<table>
<thead>
<tr>
<th>If the amount with respect to which the tentative tax to be computed is:</th>
<th>The tentative tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $10,000.</td>
<td>18 percent of such amount</td>
</tr>
<tr>
<td>Over $10,000 but not over $20,000.</td>
<td>$1,800, plus 20 percent of the excess of such amount over $10,000</td>
</tr>
<tr>
<td>Over $20,000 but not over $40,000.</td>
<td>$3,800, plus 22 percent of the excess of such amount over $20,000</td>
</tr>
<tr>
<td>Over $40,000 but not over $60,000.</td>
<td>$8,200, plus 24 percent of the excess of such amount over $40,000</td>
</tr>
<tr>
<td>Over $60,000 but not over $80,000.</td>
<td>$13,000, plus 26 percent of the excess of such amount over $60,000</td>
</tr>
<tr>
<td>Over $80,000 but not over $100,000.</td>
<td>$18,200, plus 28 percent of the excess of such amount over $80,000</td>
</tr>
<tr>
<td>Over $100,000 but not over $150,000.</td>
<td>$23,800, plus 30 percent of the excess of such amount over $100,000</td>
</tr>
<tr>
<td>Over $150,000 but not over $250,000.</td>
<td>$38,800, plus 32 percent of the excess of such amount over $150,000</td>
</tr>
<tr>
<td>Over $250,000 but not over $500,000.</td>
<td>$70,800, plus 34 percent of the excess of such amount over $250,000</td>
</tr>
<tr>
<td>Over $500,000 but not over $750,000.</td>
<td>$155,800, plus 37 percent of the excess of such amount over $500,000</td>
</tr>
<tr>
<td>Over $750,000 but not over $1,000,000.</td>
<td>$248,300, plus 39 percent of the excess of such amount over $750,000</td>
</tr>
<tr>
<td>Over $1,000,000 but not over $1,250,000.</td>
<td>$345,800, plus 41 percent of the excess of such amount over $1,000,000</td>
</tr>
<tr>
<td>Over $1,250,000 but not over $1,500,000.</td>
<td>$448,300, plus 43 percent of the excess of such amount over $1,250,000</td>
</tr>
<tr>
<td>Over $1,500,000 but not over $2,000,000.</td>
<td>$556,800, plus 45 percent of the excess of such amount over $1,500,000</td>
</tr>
<tr>
<td>Over $2,000,000 but not over $2,500,000.</td>
<td>$780,000, plus 49 percent of the excess of such amount over $2,000,000</td>
</tr>
<tr>
<td>Over $2,500,000.</td>
<td>$1,025,800, plus 50 percent of the excess of such amount over $2,500,000</td>
</tr>
</tbody>
</table>
credit was phased in beginning in 1977 with a $30,000 credit with annual increases until it reached $47,000 for 1981 and was to remain at that level.

The Economic Recovery Tax Act of 1981 increases the unified credit for gifts made after December 31, 1981, to $192,800 to be phased in according to the following schedule:34

<table>
<thead>
<tr>
<th>Year of Death Date of Gift</th>
<th>Amount of Tax Credit</th>
<th>Maximum Exemption Equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>$ 62,800</td>
<td>$225,000</td>
</tr>
<tr>
<td>1983</td>
<td>79,300</td>
<td>275,000</td>
</tr>
<tr>
<td>1984</td>
<td>96,300</td>
<td>325,000</td>
</tr>
<tr>
<td>1985</td>
<td>121,800</td>
<td>400,000</td>
</tr>
<tr>
<td>1986</td>
<td>155,800</td>
<td>500,000</td>
</tr>
<tr>
<td>1987</td>
<td>192,800</td>
<td>600,000</td>
</tr>
</tbody>
</table>

34Pub. Law 97-34, Title IV, Subtitle A, § 401, August 13, 1981.
In the above schedule the maximum exemption equivalent represents the maximum amount of taxable gifts that could be made before gift taxes would have to be paid. In the case of an estate, if no gift tax credit has been utilized, the unified credit could be applied to estate taxes permitting a taxable estate of up to the maximum exemption equivalent to pass without any estate tax being paid.

**Payment of Gift Tax**

Gift taxes are imposed on the donor of the gift rather than the recipient. For the period 1971 through 1981 inclusive the calendar quarter was the filing period for gift tax returns. For gifts made in 1982 and thereafter the filing period will be the calendar year with the filing deadline being the 15th of April following the close of the calendar year.

**THE FEDERAL ESTATE TAX STRUCTURE**

Most property or property interests which a person owns at death are subject to the federal estate tax. Estate taxes are not a tax on property but on the right to transmit property at death. The taxes are levied against the deceased person’s estate rather than upon the recipient of the property. In contrast, inheritance tax laws which are in effect in Tennessee and many other states are generally imposed on the privilege of receiving property from a decedent’s estate.

**The Gross Estate**

Under federal estate tax laws, the gross estate consists of both the property owned by the decedent at death and certain previously transferred property. Generally, the gross estate includes the value of "all property to the extent of the interest therein of the decedent at the time of his death." Several Internal Revenue Code sections refer specifically to interests of a decedent in property that might not be considered property by persons unfamiliar with the estate tax laws.

**Dower and Curtesy Interests**

Prior to the Economic Recovery Tax Act of 1981, interests of

---


36 Pub. Law 97-34, Title IV, Subtitle C, § 442 (d) (3) (1). April 13, 1981.

37 Pub. Law 97-34.

38 I. R. C., § 2033.
a surviving spouse in a decedent's property at the time of death were includible whether originating as dower or curtesy rights or by virtue of a statute creating an estate in lieu thereof. The new law expanded the marital deduction and rendered this provision of the Internal Revenue Code ineffective.

**Gifts Within Three Years of Death**

Gifts generally are included in the donor's gross estate at death if made after December 31, 1976, or if made within three years of the donor's death. Gifts that meet the requirements for the annual gift tax exclusion are not includible in the donor's gross estate with the exception of gifts of life insurance policies. Prior to changes effected by the Economic Recovery Tax Act of 1981, gifts made within three years of the donor's death were includible in his gross estate and were valued at the date of death (or six months later) rather than at the time the gift was made. The result was to include the appreciation in value of such gift property in the gross estate of the donor. For decedents dying after January 1, 1982, having made gifts within three years of death, the value placed upon the gift property will generally be the value at the time of the gift. This change in the law will eliminate appreciation in value of such gifts during the time between the gift and donor's death from being included in the gross estate.

---

39 I. R. C., § 2034.

40 The three-year rule is retained for the following categories of property, thus inflation in such property when given away within three years of death will be includible in the donor's estate.

A) Section § 303 (b) (relating to distributions in redemptions of stock to pay death taxes).

B) Section § 2032A (relating to special valuation of certain farm, etc., real property).

C) Section § 6166 (relating to extension of time for payment of estate tax where the estate consists largely of interest in closely held business).

D) Subchapter C of Chapter 64 (relating to liens for taxes).

It should be noted that "[t]he change does not modify the valuation rules with respect to transfers of property included in a decedent's gross estate because (1) the decedent retained the beneficial enjoyment of the property during life, or the power to alter, amend, or revoke a previous lifetime transfer; (2) the property was transferred previously by the decedent but the transfer takes effect at the decedent's death; (3) the decedent possessed a power of appointment over the property; or (4) with respect to the proceeds of life insurance, the decedent possessed an incident of ownership or the proceeds are receivable by the decedent's executor. Thus, such property would still be included in the decedent's gross estate at date of death fair market value. For example, if one year prior to death, a decedent transferred all incidents of ownership in a life insurance policy to a third party, the entire amount of proceeds would be included in the decedent's gross estate pursuant to Sections 2035 and 2042." Senate Report No. 97-144, p. 139.
Retained Life Interest

The gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (bona fide sales excluded) under which he retained an interest for his life. The retained interest may be either: 1) possession or enjoyment of or the right to income from the property, or 2) the right to designate, either alone or in conjunction with another person, who shall possess or enjoy the property or the income therefore. The purpose of this section is to include transfers that are similar to transfer by will because they leave the person making the transfer a significant interest in the property or control over the property during his lifetime.

Transfers Effected by Decedent’s Death

Transfers which take effect at the death of the transferor are includible in his gross estate. Generally, where two conditions prevail the transfer is said to take effect at the transferor’s death. First, where possession or enjoyment of the property can be obtained only by surviving the transferor, and secondly, where the transferor has retained a reversionary interest that exceeds 5 percent of the value of such property immediately before his death.

Revocable Transfers

Where property is transferred by gift and the transferor reserves the power to alter, amend, revoke or terminate the benefits of the property transferred, the value of such property must generally be included in the transferor’s estate. It is not necessary that the power was retained when the transfer was originally made but that the transferor had such power at death or that he had relinquished such power within three years of death. The purpose for including revocable transfers in the gross estate is to insure taxation of all incomplete transfers. Retention of any power to influence the future enjoyment of property transferred by gift has been consistently held sufficient to require inclusion in the donor-decedent’s estate. Care should be taken to remove all “strings” from intended gifts to insure gift status when the donor’s estate is settled.

---

41 I. R. C., § 2036.
42 U. S. v. Groce’s Estate. 89 S. ct. 1730.
43 I. R. C., § 2037.
44 I. R. C., § 2038.
Annuities

Annuities involve contractual arrangements by which someone acquires the right to periodic payments for life or over a period of years. Where a decedent had entered such agreement during his lifetime for providing for payments to others, known as beneficiaries, by reason of surviving the decedent, the value of the payments receivable by the beneficiaries are generally includible in the decedent’s gross estate.\(^{45}\) Annuities payable to others under a life insurance contract are excluded from the decedent’s gross estate. Certain annuities payable to beneficiaries of a decedent under trusts and retirement plans are exempt and not includible in the decedent’s estate. If annuities are involved in an estate plan and intended to be excluded from the estate at death, care should be exercised to assure that qualifying trusts or retirement plans are used.

Joint Interests

Property held jointly with other persons with a right of survivorship entitling the last survivor to the entire property is generally includible in the estate of the first joint tenant to die.\(^{46}\) However, if the survivor can show that he paid full and adequate consideration for his interest or that he inherited it or received it by gift, it is excludible from the gross estate of the first joint tenant to die. Special provisions for excluding certain jointly held property between spouses were available in the estate tax provision prior to the Economic Recovery Tax Act of 1981.\(^{47}\) However, the importance of these provisions was made ineffective by the expanded estate tax marital deduction provided in the new law.\(^{48}\)

\(^{45}\) I. R. C., § 2039.
\(^{46}\) I. R. C., § 2040.
\(^{47}\) I. R. C., § 2041 (a).
\(^{48}\) The Economic Recovery Tax Act of 1981 adopted a rule under which each spouse will be considered to own half of jointly held property regardless of which spouse furnished consideration for the property. However, due to the expanded marital deduction, the new rule will have relevance only for “determining the basis of property to the survivor (under Sec. 1014) and the qualification for certain provisions (such as current use valuation under Sec. 2032A, deferred payment of estate taxes under Sec. 6166 or 6166A, and for income taxation of redemptions to pay death taxes and administration expenses under Sec. 303).” Senate Report 97-144, p. 127. Pub. Law 97-34, Title IV, Subtitle A. § 403, August 13, 1981.
Powers of Appointment

The gross estate generally includes "the value of all property . . . to the extent of any property with respect to which a general power of appointment . . . is exercised by the decedent." If the decedent does not exercise his power or if he exercises a power limited to an ascertainable standard relating to the health, education, support or maintenance of the decedent, the value of the property subject to the power of appointment will not be includible in the decedent’s gross estate.

Life Insurance Proceeds

Proceeds from life insurance policies payable to a decedent’s estate will be includible in calculating the gross estate. Where the proceeds are payable to beneficiaries and not the estate of the decedent and where the decedent did not retain any of the "incidents of ownership," then the proceeds will not be included in the gross estate. Incidents of ownership in this context include the right to borrow against the cash value of the policy, the right to designate beneficiaries and other ownership qualities which can be exerted to influence or determine the recipient of the benefits of the insurance policy.

Disclaimers

Where a decedent has made a qualified disclaimer with respect to an interest in property, the value of such interest is excludible from his estate. Disclaimed property is considered to pass directly from the original transferor to the person entitled to receive it as result of the disclaimer.

Valuation of Assets Includible in the Gross Estate

Generally, property includible in the gross estate is valued at its fair market value on the date of death and is treated much the same as gift valuation discussed earlier in this report. However, the time for valuing property in an estate and optional valuation techniques may be available at the choice of the executor of the estate.

---

49 I. R. C., § 2041 (a).
50 I. R. C., § 2042.
51 I. R. C., § 2518.
52 Treas. Reg. § 20.2031-1 (b).
The Internal Revenue Code provides an alternative valuation date of up to six months after the owner's death, upon election by the executor of the estate. For property that is distributed, sold, exchanged or otherwise disposed of within six months after death the alternate valuation date is the date of such distribution, sale, etc.\textsuperscript{54} In the case of property not disposed of within six months of death the alternate valuation date is six months after the date of death. The alternate date permits a reduction in the amount of estate tax that would otherwise be payable in situations where the gross estate suffers shrinkage in its aggregate value during the first six months after the decedent's death.

An optimal method of valuing real property for estate tax purposes was added to the IRS code in 1966.\textsuperscript{55} Where real estate is used in farming or other closely held business and certain qualifying conditions are met, administrators of estates may elect to value qualifying real property according to its current use rather than its market value. Purpose for the provision was to reduce taxes on qualifying farm estates in order to facilitate family farm transfers. The Economic Recovery Tax Act of 1981 made several major changes in the "use valuation provisions" which relax qualifying restrictions and permit larger reductions in estate taxes.\textsuperscript{56} The decision to establish property values under the "use value provision" is not always advisable and should be made at the advice of an attorney or experienced estate planner.

**Adjustments to the Gross Estate**

Various deductions are allowed from the gross estate before the taxable estate is determined. In addition, any gifts made after 1976 which required a gift tax return must be included with the gross estate in determining the taxable estate. Gifts covered by the annual gift tax exclusion do not require a gift tax return and are not considered in determining the gross estate or the taxable estate.

**Expenses, Debts, Taxes**

For estate tax purposes the value of the taxable estate is determined by deducting the amount of various claims against the estate. Funeral and estate administration expenses can be deducted along with unpaid mortgages on or any indebtedness associated with a decedent's property for which a reduction was not made when the

\textsuperscript{54} I. R. C., § 2032 (a) (1).
\textsuperscript{55} I. R. C., § 2032A.
\textsuperscript{56} Pub. Law 97-34, Title IV, Subtitle C, § 421, August 13, 1981.
property interest was valued in the gross estate. In addition, bona
fide claims against the estate and state and foreign death taxes, with
certain limitations, are deductible from the gross estate.

**Casualty and Theft Losses**

A deduction is permitted from the gross estate for losses to estate
property incurred during the estate settlement process. When not
compensated for by insurance or otherwise, losses of estate assets
arising from fires, storms, shipwrecks or other casualties or from
theft are deductible and not subject to the estate tax.

**Charitable Transfers**

Generally all bequests, devises or transfers for public, charitable
and religious uses are deductible in computing the taxable estate.
Gifts to the U. S. Government, state governments and local govern-
ments should be for exclusively public purposes. Transfers made for
charitable and religious purposes are deductible if the organization
receiving them is operated exclusively for religious, charitable,
scientific, literary or educational purposes. No part of the earnings of
such charities should benefit any private stockholder of such organ-
ization, nor should profits be used to influence legislation or to inter-
vene in a political campaign on behalf of a candidate for public office.

**Marital Deduction**

The estate tax marital deduction has been liberalized considerably
in recent years. Prior to the Economic Recovery Tax Act of 1981 the
marital deduction was half of the gross estate or $250,000 whichever
was greater. Under the new law effective on January 1, 1982, an
unlimited marital deduction applies. Outright transfers to a spouse
up to all of a decedent's estate are now deductible for determining
the taxable estate. Under prior law, transfers of certain termi-
nable interests such as a life estate in property or a life income
interest in a trust did not qualify for the estate tax marital deduction.
Under the Economic Recovery Tax Act of 1981 such terminal in-
terests may qualify for the marital deduction if the donor or the
executor of the estate so elects.

---

57 I. R. C., § 2053.
58 I. R. C., § 2054.
59 I. R. C., § 2055.
60 I. R. C., § 2056 (as amended Pub. Law 99-34, Title IV, § 403).
61 Pub. Law 97-34, Title IV, Subtitle C, § 403 (d), August 13, 1981.
Orphans Exclusion

An orphan's exclusion was enacted as part of the Tax Reform Act of 1976. For decedents dying after December 31, 1976, and before January 1, 1982, this provision applies but was repealed by the Economic Recovery Act of 1981. Under orphans exclusion provisions, the estate of a decedent, leaving children under 22 years of age with no known surviving parent, is entitled to a deduction for transfers of property (other than transfers of future interests) to such children. The deduction to each child is limited to $5,000 multiplied by the number by which 21 exceeds the child's age in years on the date of the decedent's death.

Taxable Amount—Tentative Tax

The amount with respect to which the estate tax is computed is obtained by subtracting allowable deductions from the value of all assets includable in the estate and adding the value of gifts made after 1976. The tax from the unified tax rate schedule can then be computed (Table 1). At this point, the aggregate amount of gift taxes on transfers by gift after 1976 are subtracted to obtain the tentative estate tax. Various credits are deductible from this tentative tax in establishing the amount of estate tax payable.

Estate Tax Credits

Several credits are provided, all of which seldom apply to a particular estate. As a general rule, a proportionately greater reduction in the tentative estate tax can be expected in smaller estates than in larger ones from estate tax credits. However, estate tax credits are important in all taxable estates.

The Unified Credit

The unified credit was discussed earlier in this report because it applies to the gift tax as well as the estate tax. Since the estate and gift taxes are now unified, this credit is deducted when an estate is closed even if the entire amount had previously been applied to offset gift taxes. Because the amount of taxable gifts made after 1976 has been included in determining the taxable estate, application of the unified credit to offset estate taxes does not represent a double application of the credit.

62 I. R. C., § 2057 (repealed Pub. Law 97-34, Title IV, § 427).
63 I. R. C., § 2011.
**State Death Tax Credit**

A credit is allowed against the federal estate tax for the amount of any estate, inheritance, legacy or succession taxes actually paid to any state government in respect to property that is included in the gross estate.\(^{64}\) The amount of the credit allowed for state death taxes is limited and must be calculated from a table (see Table 2).

**Credit for Gift Taxes Paid**

A credit is allowed against the federal estate tax for gift tax paid on pre-1977 gift property that is includible in the gross estate. This credit is limited to the lesser of 1) the gift tax paid or 2) the amount of estate tax attributable to the gift property being included in the gross estate.\(^{65}\) In order to assess the credit, separate computations are necessary for each gift.

**Tax on Prior Transfers**

A federal estate tax credit is available with respect to the transfer of property to a decedent by or from a person who died within 10 years before, or within two years after the decedent’s death.\(^{66}\) It is necessary that the transfer of the property was included in the gross estate of the transferor and was subjected to the federal estate tax. The credit is limited to the smaller of 1) the amount of the federal estate tax attributable to the transferred property in the transferor’s estate or 2) the amount of the federal estate tax attributable to the transferred property in the decedent’s estate. A further percentage limitation is imposed where the transferor’s death is more than two years from the decedent’s death. In such cases, the credit is a percentage of the smaller of the two limitations outlined above and is determined as follows:

1. Eighty percent, if the transferor died within the third or fourth years preceding the present decedent’s death.
2. Sixty percent, if the transferor died within the fifth or sixth years preceding the present decedent’s death.
3. Forty percent, if the transferor died within the seventh or eighth years preceding the present decedent’s death.
4. Twenty percent, if the transferor died within the ninth or tenth years preceding the present decedent’s death.

---

\(^{64}\) I. R. C., § 2012.

\(^{65}\) I. R. C., § 2012.

\(^{66}\) I. R. C., § 2013.
### Table 2. Schedule of Credits Allowed on Federal Estate Tax Return for State Death Taxes Paid (Source: I.R.C., § 2011)

<table>
<thead>
<tr>
<th>If the adjusted taxable estate&lt;sup&gt;a&lt;/sup&gt; is:</th>
<th>The maximum tax credit shall be:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $90,000</td>
<td>8/10ths of 1% of the amount by which the taxable estate exceeds $40,000</td>
</tr>
<tr>
<td>Over $90,000 but not over $140,000</td>
<td>$400 plus 1.6% of the excess over $90,000</td>
</tr>
<tr>
<td>Over $140,000 but not over $240,000</td>
<td>$1,200 plus 2.4% of the excess over $140,000</td>
</tr>
<tr>
<td>Over $240,000 but not over $440,000</td>
<td>$3,600 plus 3.2% of the excess over $240,000</td>
</tr>
<tr>
<td>Over $440,000 but not over $640,000</td>
<td>$10,000 plus 4% of the excess over $440,000</td>
</tr>
<tr>
<td>Over $640,000 but not over $840,000</td>
<td>$18,000 plus 4.8% of the excess over $640,000</td>
</tr>
<tr>
<td>Over $840,000 but not over $1,040,000</td>
<td>$27,600 plus 5.6% of the excess over $840,000</td>
</tr>
<tr>
<td>Over $1,040,000 but not over $1,540,000</td>
<td>$38,800 plus 6.4% of the excess over $1,040,000</td>
</tr>
<tr>
<td>Over $1,540,000 but not over $2,040,000</td>
<td>$70,800 plus 7.2% of the excess over $1,540,000</td>
</tr>
<tr>
<td>Over $2,040,000 but not over $2,540,000</td>
<td>$106,800 plus 8% of the excess over $2,040,000</td>
</tr>
<tr>
<td>Over $2,540,000 but not over $3,040,000</td>
<td>$146,800 plus 8.8% of the excess over $2,540,000</td>
</tr>
<tr>
<td>Over $3,040,000 but not over $3,540,000</td>
<td>$190,800 plus 9.6% of the excess over $3,040,000</td>
</tr>
<tr>
<td>Over $3,540,000 but not over $4,040,000</td>
<td>$238,800 plus 10.4% of the excess over $3,540,000</td>
</tr>
<tr>
<td>Over $4,040,000 but not over $5,040,000</td>
<td>$290,800 plus 11.2% of the excess over $4,040,000</td>
</tr>
<tr>
<td>Over $5,040,000 but not over $6,040,000</td>
<td>$402,800 plus 12% of the excess over $5,040,000</td>
</tr>
<tr>
<td>Over $6,040,000 but not over $7,040,000</td>
<td>$522,800 plus 12.8% of the excess over $6,040,000</td>
</tr>
<tr>
<td>Over $7,040,000 but not over $8,040,000</td>
<td>$650,800 plus 13.6% of the excess over $7,040,000</td>
</tr>
<tr>
<td>Over $8,040,000 but not over $9,040,000</td>
<td>$786,800 plus 14.4% of the excess over $8,040,000</td>
</tr>
<tr>
<td>Over $9,040,000 but not over $10,040,000</td>
<td>$930,800 plus 15.2% of the excess over $9,040,000</td>
</tr>
<tr>
<td>Over $10,040,000.</td>
<td>$1,082,800 plus 16% of the excess over $10,040,000</td>
</tr>
</tbody>
</table>

<sup>a</sup> For purposes of this table, the term “adjusted taxable estate” means the taxable estate reduced by $60,000.
Foreign Death Taxes

A credit is allowed against the federal estate tax for death taxes paid to a foreign country or subdivision thereof with respect to property situated within the country to which the tax is paid.\textsuperscript{67} The credit is available to decedents who are citizens or residents of the U.S. at the time of death and applies only to property that is includible in the gross estate for federal estate tax purposes.

Estate Tax Payable

After all credits available are applied to the tentative estate tax, any remaining balance is the estate tax due or payable. To avoid penalty and interest charges, estate tax returns should normally be filed within nine months after the date of the decedent's death.\textsuperscript{68} Generally, the estate tax is due with the filing of the return. However, a reasonable extension of time for filing the estate tax return or for making payment of the estate tax may be granted at the discretion of the secretary of the treasury.\textsuperscript{69} In addition, certain closely held businesses may qualify for deferred payment of estate taxes. The Economic Recovery Tax Act of 1981 simplified and coordinated two existing deferred payment schemes (§ 6166 and § 6166A of the IRS code) to provide a single set of rules to govern the estate tax treatment of interests in a closely held business.\textsuperscript{70} Under the new rules deferred payment of estate taxes will be available to all estates in which the value of a closely held business exceeds 35 percent of the value of the gross estate or 50 percent of the taxable estate. Estates qualifying for deferred payments can pay only interest payments for five years followed by 10 annual installments of principal and interest.

\textsuperscript{67} I. R. C., § 2014.
\textsuperscript{68} I. R. C., § 6075 (a).
\textsuperscript{69} I. R. C., § 6161 (a); 6181 (a).
\textsuperscript{70} Pub. Law 97-34, Title IV, Subtitle C, § 422, August 13, 1981.
SUMMARY

Recent changes in the federal estate and gift tax laws permit intergenerational transfer of moderately large estates without payment of either estate or gift taxes. Annual gifts of up to $10,000 per donee can now be made without filing a gift tax return or paying any tax. Through the gift splitting provisions the annual gift exclusion can effectively be raised to $20,000 for a married person if that person’s spouse consents to the gifts. The marital deduction is now unlimited so that payment of gift taxes on gifts between spouses and payment of estate taxes on property received from a deceased spouse estate is now obsolete. The unified estate and gift tax credit has been increased to $192,800 effective in 1987 with annual increases phased in until that limit is reached. For decedents dying in 1987 and thereafter the unified credit provides an exemption equivalent of $600,000. When the exemption equivalent reaches the 1987 level, a deceased person’s estate can be up to $600,000 in addition to any qualifying property received by the decedent’s spouse before any estate taxes will apply.

Estate and gift tax laws are rather complex. Due to that complexity, it is wise to consult experienced attorneys or other estate planning professionals when a lifetime giving and/or estate plan is developed.
THE UNIVERSITY OF TENNESSEE
AGRICULTURAL EXPERIMENT STATION
KNOXVILLE, TENNESSEE 37916
E11-1107-03-001-83

Agricultural Committee, Board of Trustees
Edward J. Boling, President of the University;
William M. Johnson, Chairman;
William H. Walker, Commissioner of Agriculture, Vice Chairman;
Jack J. Craddock, James F. Harrison; Ben S. Kimbrough;
Turner O. Lashlee;
W. W. Armistead, Vice President for Agriculture

STATION OFFICERS
Administration
Edward J. Boling, President
W. W. Armistead, Vice President for Agriculture
B. H. Pentecost, Assistant Vice President
D. M. Gossett, Dean
T. J. Whatley, Associate Dean
J. I. Sewell, Assistant Dean
O. Clinton Shelby, Director of Business Affairs
Bill J. Reed, Director of Communications
Fletcher Luck, Director of Services

Department Heads
J. A. Martin, Agricultural Economics and Rural Sociology
D. H. Luttrell, Agricultural Engineering
D. O. Richardson, Acting, Animal Science
Priscilla N. White, Child and Family Studies
Carroll J. Southards, Entomology and Plant Pathology
Betty R. Carruth, Nutrition and Food Sciences
J. T. Miles, Food Technology and Science
Gary Schneider, Forestry, Wildlife, and Fisheries
G. D. Crater, Ornamental Horticulture and Landscape Design
L. F. Seatz, Plant and Soil Science
Jacqueline Y. DeJonge, Textiles, Merchandising and Design

BRANCH STATIONS
Ames Plantation, Grand Junction, James M. Anderson, Superintendent
Dairy Experiment Station, Lewisburg, J. R. Owen, Superintendent
Forestry Experiment Station: Locations at Oak Ridge, Tullahoma, and
Wartburg, Richard M. Evans, Superintendent
Highland Rim Experiment Station, Springfield, L. M. Safley, Superintendent
Knoxville Experiment Station, Knoxville, John Hodges III, Superintendent
Martin Experiment Station, Martin, H. A. Henderson, Superintendent
Middle Tennessee Experiment Station, Spring Hill, J. W. High, Jr., Superintendent
Milan Experiment Station, Milan, T. C. McCutchen, Superintendent
Plateau Experiment Station, Crossville, R. D. Freeland, Superintendent
Tobacco Experiment Station, Greeneville, Philip P. Hunter, Superintendent
West Tennessee Experiment Station, Brown, Superintendent

2129 2292 35
12-07-00
MAB