VORYS

Publications

Federal Transfer Tax Basics

Related Attorneys

Victor J. Ferguson

David A. Groenke

Emily S. Pan

Michael G. Schwartz

Mark E. Vannatta

Related Services

Trusts, Estates and Wealth Transfer

AUTHORED ARTICLE | 11.18.2015

Legacy

The following article was featured in the November 2015 edition of *Legacy*, the Vorys newsletter focused on wealth planning.

--

There are three federal wealth transfer taxes: (1) the estate tax; (2) the gift tax; and (3) the generation-skipping transfer (GST) tax. Each wealth transfer tax has an amount that may be transferred before the respective tax is imposed. Each such amount is referred to herein as an "exemption." The estate tax and gift tax exemptions are $5.43 million in 2015. However, the use of any gift tax exemption reduces the available estate tax exemption at death by a corresponding amount. The generation-skipping transfer tax has a separate exemption that also equals $5.43 million in 2015. Each exemption is indexed for inflation annually and all are expected to increase to $5.45 million in 2016.

The estate tax is generally imposed on the transfer of property owned at death. It may also be imposed on property over which the decedent possessed some beneficial enjoyment or retained power. For example, if a decedent held a general power of appointment (the right to appoint property to herself, her estate, her creditors, or the creditors of her estate), the value of the property subject to the general power of appointment would be includible in the decedent's estate.

The gift tax is generally imposed on transfers for less than full and adequate consideration in money or money's worth. This encompasses gifts in which no consideration is received in return. It also encompasses bargain sales. For instance, if a parent "sells" property with a fair market value of $1 million to a child for $100,000, then the parent has made a $900,000 gift to the child. In that example, parent would be forced to use a portion of his or her available gift tax exemption or, if such exemption had been previously used, pay gift tax. In some instances, making gifts and using gift tax exemption (or even paying gift tax if all gift tax exemption has been used) can reduce anticipated estate taxes and result in an increase in the amount of assets transferred to heirs.

There is also a gift tax annual exclusion, which allows persons to transfer up to an aggregate amount of $14,000 (as of 2015) to any person without using any gift tax exemption. Making annual exclusion gifts to multiple family members and their spouses can be a beneficial strategy for wealthy persons with large families.

There are two major unlimited estate and gift tax deductions: (1) the marital deduction; and (2) the charitable deduction. The marital deduction allows a married individual to make transfers during life or at death in unlimited amounts to such individual's spouse. If the transfer to the spouse is actually a transfer to a trust for the spouse's benefit, then the trust must meet certain requirements to qualify for the marital deduction. The charitable deduction allows an individual to make transfers in unlimited amounts to one or more charities without being subject to gift or estate taxation.

The estate tax is "portable," meaning that if a decedent's estate does not fully use the decedent's estate tax exemption, and the decedent is survived by his or her spouse, the surviving spouse is allowed to use the decedent's unused estate tax exemption (subject to some exceptions). This is known as "portability." ***Example:*** *Jack and Jill are married. Jack made a lifetime taxable gift of $1 million to their only daughter. Jack dies in 2015, with $4.43 million of estate tax exemption. At Jack's death, he owns $1 million of assets and leaves all such assets to Jill. The gift to Jill qualifies for the unlimited marital deduction, and thus, at Jack's death he would have used none of his remaining estate tax exemption. Therefore, Jack's remaining estate tax exemption ($4.43 million) is available for Jill to use.*

In an effort to avoid the imposition of the estate tax at each generation, people began making transfers that "skip" their children and instead pass to or for the benefit of grandchildren or more remote descendants. The GST tax was enacted in response to such efforts and it arises in three scenarios. First, it is imposed on a direct skip, which is a transfer to a "skip person." The definition of a "skip person" is detailed and subject to exceptions, but the most common example of a skip person is a grandchild. An example of a direct skip is a transfer by a grandparent to a grandchild which "skips" such grandparent's child. Second, the GST tax is imposed on a taxable distribution from a trust to a "skip person." Finally, the GST tax is imposed on a "taxable termination," which generally occurs when non-skip persons no longer have an interest in the trust property and skip persons are trust beneficiaries.

Unlike the estate tax exemption, the GST tax exemption is not portable. As such, couples with combined assets that currently exceed, or are anticipated to exceed in the future, the GST tax exemption should engage in proper planning to fully utilize GST tax exemption.

Despite the existence of the GST tax, the GST tax exemption makes it possible for wealthy families to structure dynasty trusts to leverage their GST tax exemption. When such dynasty trusts are created and funded, and the GST tax exemption has been properly allocated to them, they may benefit multiple generations (including children) and the funds will not be subject to estate tax for as long as they remain in trust. Many states, including Ohio, have changed their laws in recent years to provide that assets may remain in trusts for several generations. The combination of these laws and the relatively large GST tax exemption make dynasty trusts an attractive tool for wealthy families who are interested in sheltering substantial assets from estate taxation for multiple generations.

The laws discussed in this newsletter may differ with respect to persons who are not U.S. citizens and U.S. resident aliens.

Contact your Vorys attorney if you would like to discuss techniques to minimize or eliminate the impact of wealth transfer taxes on your family.