FUNDAMENTALS
OF
ESTATE TAX AND GIFT TAX

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I. INTRODUCTION

A. The Tax Reform Act of 1976 (the "1976 Act") established a unified rate schedule and a unified credit which applies both to transfers during life and transfers at death. The Economic Recovery Tax Act of 1981 ("ERTA") increased the unified credit and the Taxpayer Relief Act of 1997 (the "1997 Act") further increased the credit. The Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Act”) increases the unified credit beginning in 2002 and creates in 2004 a different credit for transfers during life and transfers at death.

B. Although one single rate structure applies until 2004 both to lifetime gifts and to transfers at death, the fundamental questions of what constitutes a taxable gift and what assets are includable in a decedent's gross estate are (subject to a few special statutory modifications) basically unchanged.

C. Although the rate structure has been unified until 2004, no attempt has been made to unify the gift tax and estate tax in any philosophical sense.

   1. Thus, some transfers will still be treated as completed gifts for tax purposes but will still be subject to full inclusion in the gross estate.

   2. The most common example of a transfer subject both to gift tax and estate tax is a gift with a retained life estate.

D. Following the gradual increases in the unified credit beginning in 2002 and the generation skipping tax beginning in 2004, the 2001 Act repeals the estate tax and the generation skipping tax for persons who die in 2010, but the 2001 Act reinstates the estate tax and generation skipping tax in its form prior to the 2001 Act for persons dying after 2010. The gift tax is not repealed.

II. THE FEDERAL ESTATE TAX: THE GROSS ESTATE

A. The starting point in computing the federal estate tax is the "gross estate", which consists of the following:
1. Property Owned at Death. Section 2033 of the Internal Revenue Code of 1986, as amended (the "Code").
   a. This includes essentially the items found in the decedent's probate estate.
   b. However, foreign real estate is included.

2. Joint Tenancy (and other forms of joint ownership with right of survivorship, such as tenancy by entirety in states where it exists). Section 2040 of the Code.
   a. The general rule is that the gross estate includes property with respect to which the decedent was a joint tenant, except to the extent that the surviving joint tenant or tenants can show contribution (which never came from the decedent by way of gift) to the acquisition of the property.
   b. ERTA adopted the simple rule that if an interest in property is held by decedent and his spouse as tenants by the entireties or as joint tenants with right of survivorship (provided the decedent and the spouse are the only joint tenants), one-half of the value of the jointly owned interest will be included in the estate of the decedent regardless of which spouse furnished the original consideration. Section 2040(b)(2) of the Code.
   c. In addition, ERTA repealed the material participation rule, the rules concerning retroactivity of the fractional interest rule and the gift tax provisions governing the creation of spouses' joint interests.
   d. Since present interest gifts to a spouse now qualify for the unlimited gift tax marital deduction and are exempt from gift tax, it no longer matters, for gift tax purposes, whether the creation of a joint interest in property between spouses constitutes a gift.
   e. The joint tenancy rules do not apply to tenancy in common property, the decedent's interest in which is included under Section 2033 of the Code.

   a. Definition: A general power of appointment is one exercisable by the decedent in favor of herself or himself, his or her estate, his or her creditors, or the creditors of the estate. All others are special powers of appointment.

   b. Major exceptions:

      i. Power limited by an ascertainable standard relating to health, education, support or maintenance is not a general power. Section 2041(b)(1)(A) of the Code.

         (1) The Internal Revenue Service (the "Service") has ruled that a non-general power may be held by an individual serving as sole trustee and income beneficiary, if the statutory language is strictly followed. Rev. Rul. 78-398, 1978-2 C.B. 237.

      ii. A power held jointly with a substantially adverse party or with the creator of the power is not a general power.

      iii. A general power created before 1942 results in estate taxation only if exercised.

      iv. Lapse of power to appoint the greater of $5,000 or 5% of trust corpus is not subject to normal rules applicable to lapses or releases. Section 2041(b)(2) of the Code.

   c. Section 2044 of the Code provides that the value of a decedent's gross estate shall include the value of any property in which the decedent had a qualifying income interest for life and for which a deduction was allowed with respect to the transfer of such property to the decedent. As will be noted subsequently, such inclusion is the price paid for the tax deferral granted by the unlimited marital deduction provisions.


   a. The long standing "three year" rule which required that property given away by a decedent within three years before death be
included in the gross estate was abolished for estates of decedents dying after 1981, except for limited purposes and subject to specified exceptions. Apart from these limited purposes and exceptions, no part of the value of property which a decedent has transferred by gift within three years of death will be included in the gross estate under the "three year" rule.

i. The effect of this change is to free from estate tax any appreciation in value of the property between the date of gift and the date of decedent's death. This frees such post gift appreciation from transfer taxes entirely, since that appreciation also escapes gift tax.

b. This change removes the distinction made by the 1976 Act between gifts made within three years of a decedent's death and gifts made more than three years before death. For estates of decedents dying after 1981, both types of gifts will be treated for estate tax purposes in the same manner. They will not be included in the decedent's gross estate and will enter into the estate tax computation only to the extent that they constitute "adjusted taxable gifts."

c. Inclusion in the gross estate of the gift tax on gifts made within three years of death is referred to as "grossing up."

5. Transfers with Retained Income, Possession or Enjoyment. Section 2036(a)(1) of the Code.

a. The retained life estate need not be expressed. For example, it has been held that an outright gift, without any restrictions, of a house by an individual to a child followed by retained possession by the donor gives rise to an inference of an implied retention of a life estate. Rev. Rul. 78-409, 1978-2 C.B. 234. Contrast Rev. Rul. 70-155, 1970-1 C.B. 189 (a transfer of a home to a spouse with the transferor continuing to reside there until death resulted in no inclusion in grantor's estate).


a. The 1976 Act (as modified by the Revenue Act of 1978) expanded the definition of retained enjoyment under Section 2036(a)(1) to include the retention of voting rights in transferred