Michael V. Vollmer

Attorney at Law
5020 Campus Drive
Newport Beach, California 92660
Telephone 949.474.9088
Facsimile 949.474.9089 E-mail mike@vollmerlaw.net
Certified Specialist, Estate Planning, Trust and Probate Law, The State Bar of California Board of Legal Specialization

OVERVIEW OF GIFT AND ESTATE TAXES, INCOME TAX BASIS RULES, AND CALIFORNIA REAL PROPERTY TAXES
(Effective January 1, 2018)

1. Federal <u>Gift</u> Tax ["FGT"] rules. The FGT is a tax that the federal government may assess on your right to give away assets <u>during your lifetime</u>.

a. 100% exclusion for qualifying transfers to a spouse or charity. You may give unlimited gifts to your spouse [who is a United States citizen] or to qualified charities without payment of any FGT.

b. $15,000 annual exclusion. In 2018 you may give away in each calendar year $15,000 to any number of recipients without payment of any FGT. Usually these "smaller" gifts do not have to be reported, and the gifts are not included as income to the recipient.

c. Additional lifetime exclusion. You may make additional lifetime gifts totaling $11,180,000 <u>in the aggregate</u> during your lifetime, without payment of any FGT. These larger gifts must be reported on U.S. Treasury Form 709 (due on April 15th of the year following the gift being made). The amount of the lifetime FGT exclusion used reduces (on a dollar for dollar basis) the exclusion available for FET at your death.

d. The lifetime exclusion may change in 2026. The lifetime exclusion amount is scheduled to be reduced to only $5,600,000 for gifts made after 2025.

e. 40% gift tax rate on excess gifts. If your total lifetime gifts exceed the lifetime exclusion amount, the excess is taxed at 40%.

f. Strategies. For very high net worth individuals, a program of lifetime gifts (especially before 2026) may be beneficial for both tax and practical reasons. A program might involve annual exclusion gifts, 529 Plan (educational) gifts, direct payments to providers for tuition and medical expenses, qualified personal residence trusts (QPRTs), irrevocable life insurance trusts (ILITs), charitable remainder trusts (CRTs), intentionally "defective" grantor trusts (IDGTs), private annuities, the creation of limited partnerships and limited liability companies (LLCs), and other vehicles.

2. Federal <u>Estate</u> Tax ["FET"] rules. The FET is a tax that the federal government may impose on your right to give away assets <u>at your death</u>.

a. Due date. The FET is due and payable in full nine months following your death, unless an extension or long term payment plan is available.

b. Computation. The FET is assessed against your "net estate", computed as follows:

(1) First you value your gross assets at fair market value (<u>not</u> cost). This includes

proceeds payable at death from life insurance policies, and pension and profit-sharing plan benefits, if you have the right to designate who will receive them at your death.

(2) Next, you deduct any mortgages, debts, funeral expenses, and administration expenses.

c. 100% exclusion for qualifying transfers to a spouse. You may give unlimited qualifying transfers to your spouse [if a United States citizen] without payment of any FET. This includes outright transfers. It also includes transfers made in a qualifying manner, such as a Qualified Terminable Interest Property ["QTIP"] Trust. If your spouse is not a United States citizen, then the exclusion must satisfy many technical "Qualified Domestic Trust" ["QDOT"] requirements.

d. 100% exclusion for qualifying transfers to a charity. There is no FET on any assets that pass at your death to a qualifying charity (either outright or in a qualifying manner.

e. Additional exclusion amount; tax rates.

(1) **For deaths between 2018 through 2025**, there is no FET payable on the first **$11,180,000** of assets you transfer to persons other than your qualifying spouse or charity. Excess assets are taxed at a **40%** flat rate.

(2) **For deaths after 2025**, the exclusion amount is scheduled to decrease to only $5,600,000 per spouse.

(3) **Portability of a Deceased Spouse's Unused Exclusion Amount ("DSUEA")**. If you die without using your full exclusion amount, then your unused exclusion amount may pass ("be ported") to your surviving spouse. Here is an illustration:

(A) You die in 2018, leaving $2,000,000 to your children and everything else to your spouse. In other words, you did not use $9,180,000 of your available $11,180,000 total available exclusion.

(B) At your spouse's subsequent death, your unused $9,180,000 exclusion ($11,180,000 less $2,000,000 transfers to your children) may be added to your spouse's own then available exclusion ($11,180,000 for deaths prior to 2026), for a total available FET exclusion at your spouse's death of $20,360,000.

(C) You must follow specific rules to qualify for portability, but they are not onerous.

(3) Unification of FGT and FET. If you give away $5,000,000 of your exclusion during your lifetime, then you only have $6,180,000 of your total exclusion to use at your death. In other words, you have only one $11,180,000 combined [unified] FGT and FET exclusion. You can use your exclusion entirely during lifetime (so you would have no exclusion left at your death); or you can use the exclusion entirely at your death; or you can use part of the exclusion during your lifetime and the balance at your death.

(4) Additional Generation Skipping Transfer Tax ["GSTT"] rules. If you makes gifts by "skipping a generation" [such as skipping your living children and transferring assets to your grandchildren], then there may be an additional 40% tax assessed if your total gifts to the lower generation exceeds $11,180,000 in the aggregate.

(5) Strategies. Our tax laws may be different at the date of each spouse's death. For example, one death may occur prior to 2026, with a $11,180,000 FET exclusion; and the other death after 2025 with a possible FET exclusion of only $5,600,000. You, your spouse, and the Trustee of a trust you create, may chose how (or whether) to take maximum advantage of two exclusions for FET and GSTT purposes. For example, the Trustee might make any of a number of choices:

(A) If the FET exclusion at the surviving spouse's death seems likely to be significantly reduced [for example, for a death in 2026 or later], then the Trustee might treat the irrevocable part of the trust created at the first spouse's death [a Marital Trust or a By-Pass Trust or an exclusion trust equivalent) as using the first spouse's exemption equivalent; and not claim "portability" of the irrevocable portion.

(B) If the FET exclusion seems likely to remain high, and if claiming portability will have income tax basis advantages (without incurring any added FET) at the surviving spouse's death, then the Trustee might treat the first spouse's irrevocable trust as a "QTIP" Trust.

(C) If it appears that a child or other beneficiary is ill, and that beneficiary's share would likely pass to more distant generations, then treating the first spouse's irrevocable trust as an exclusion trust might avoid GSTT.

(D) If necessary, the Trustee might divide the first spouse's irrevocable trust into two or more subtrusts: one By-Pass Trust [exclusion trust equivalent] portion, and one QTIP Trust portion.

3. No Separate California Estate Tax. California no longer has an inheritance or estate tax. If a California decedent owns real properties <u>outside</u> California, however, those other states may (or may not) impose their own estate or inheritance tax.

4. Income Tax Basis Rules. If you sell an asset during your lifetime, you may have to pay an income tax on the capital gain (sales price less cost basis = capital gain). At your death, however, your cost basis for most assets is increased to fair market value at the date of your death [IRC Section 1014]. Therefore, if your beneficiary sells the asset following your death at the date of death value, the beneficiary will have no capital gain to report, and will pay no capital gains tax. For community property assets owned at death, both of the spouse's 50% interest in assets receives a "step-up" in basis, which is very beneficial. This "step-up" in basis does <u>not</u> apply to individual retirement accounts and qualified retirement plan benefits.

5. Real Property Tax Rules. When you transfer California real properties to beneficiaries (outright or in trust), the real property taxes may be reassessed (increased) under Proposition 13. The rules are complex, but the following general outline may be helpful:

a. Spousal Exclusion. There is no reassessment (increase in real property taxes) when you pass real property outright to, or in special trust ways for the benefit of, your spouse.

b. Limited Parent-Child Exclusion. There is no reassessment (increase in real property taxes) on the following transfers of real property to your children (so long as the transfers are made outright or in special qualifying trusts):

(1) Your principal residence of any value.

(2) Other real properties with an aggregate <u>assessed value</u> of $1,000,000 or less.

c. Special Entity Rules. If title to your real property is in the name of an entity (such as a corporation, or a limited partnership, or a limited liability company), then the parent-child exclusion is <u>not</u> available; a special form (Board of Equalization Form 100-B) must be filed within ninety days following your death; and when more than 50% of the total ownership of the entity changes hands, there may be a reassessment of 100% of the real property owned by the entity.