How do the estate, gift, and generation-skipping transfer taxes work?

The federal estate tax applies to the transfer of property at death. The gift tax applies to transfers made while a person is living. The generation-skipping transfer tax is an additional tax on a transfer of property that skips a generation.

The United States has taxed the estates of deceased people since 1916. In 1976, Congress linked taxes on estates, gifts made during life (*inter vivos* gifts), and generation-skipping transfers (GST). The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut all three taxes sharply, but only through 2010. The act gradually phased out the estate and GST taxes, and repealed both entirely for 2010, leaving only the gift tax (at a reduced rate) in effect that year.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate and GST taxes for 2010 and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent, but allowed executors to elect the EGTRRA rules for decedents who died in 2010. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012, but the top rate was increased to 40 percent.

Here's how the estate tax works:

- The executor of an estate must file a federal estate tax return within nine months of a person's death if that person's gross estate exceeds the exempt amount ($5.43 million in 2015; table 1).
- The estate tax applies to a decedent's gross estate, which generally includes all the decedent's assets, both financial (e.g., stocks, bonds, and mutual funds) and real (e.g., homes, land, and other tangible property). It also includes the decedent's share of jointly owned assets and life insurance proceeds from policies owned by the decedent.
- The estate tax allows an unlimited deduction for transfers to a surviving spouse and to charity. Estates may also deduct debts, funeral expenses, legal and administrative fees, charitable bequests, and estate taxes paid to states. The taxable estate equals the gross estate less these deductions.
- A credit then effectively exempts a large portion of the estate: in 2015, the effective exemption is $5.43 million. Any value of the estate over $5.43 million is generally taxed at the top rate of 40 percent.
- Although tax rates are graduated, all transfers in excess of the exemption are taxed at the top rate because the exemption exceeds the threshold at which the top rate applies.

- Special provisions reduce the tax, or spread payments over time, for family-owned farms and closely-held businesses. Estates that satisfy certain conditions may use a special-use formula to reduce the taxable value of their real estate, often by 40 to 70 percent. Estates where farms or businesses make up at least 35 percent of gross estate may pay the tax in installments over 14 years at reduced interest rates, with only interest due during the first five years.
- Regardless of size, inheritances are not taxable income to the recipient.

Here's how the gift tax works:

- Congress enacted the gift tax in 1932 to prevent donors from avoiding the estate tax by transferring their wealth before they died.
- The tax provides a lifetime exemption of $5.43 million per donor in 2015. This exemption is the same that applies to the estate tax and is integrated with it (i.e., gifts reduce the exemption amount available for estate tax purposes). Beyond that exemption, donors pay gift tax at the same top rate (40 percent) that applies for estate tax purposes.
- An additional amount each year is also exempted from both the gift tax and the lifetime exemption. This exemption, $14,000 in 2015, is indexed for inflation in $1,000 increments and is granted separately for each recipient. Thus, a married couple with three children could give their children a total of $84,000 each year ($14,000 from each parent to each child) without owing tax or counting toward the lifetime exemption.
- Regardless of size, gifts received are not taxable income to the recipient.

And here's how the generation-skipping trust tax works:

- Congress enacted the GST tax in 1976 to prevent families from avoiding the estate tax for one or more generations by making gifts or bequests directly to grandchildren or great-grandchildren. The GST tax effectively imposes a second layer of tax (using the exemption and the top tax rate under the estate tax) on wealth transfers to recipients who are two or more generations younger than the donor.

TABLE 1

Estate, Gift, and GST Tax Rates and Exemptions under Current Law
2007-2015

Year	Estate and GST tax rate	Gift tax rate	Estate and GST tax exemptions	Lifetime gift exemptions	Annual gift exemptions
2007	45%	45%	$2 million	$1 million	$12,000
2008	45%	45%	$2 million	$1 million	$12,000
2009	45%	45%	$3.5 million	$1 million	$13,000
2010	0%[a]	35%	N/A[b]	$1 million	$13,000
2011	35%	35%	$5 million	$5 million	$13,000
2012	35%	35%	$5.12 million	$5.12 million	$13,000
2013	40%	40%	$5.25 million	$5.25 million	$14,000
2014	40%	40%	$5.34 million	$5.34 million	$14,000
2015	40%	40%	$5.43 million	$5.43 million	$14,000

Source: Internal Revenue Code.
(a) The exemption, which was $10,000 in 1998, is indexed for inflation in $1,000.
(b) Executors can elect to apply the EGGTRA rules, which repealed the estate tax for 2010, but otherwise the 2011 parameters apply.

DATA SOURCES

Internal Revenue Code. 26 USC Subtitle B: Estate and Gift Taxes.

FURTHER READING

Harris, Benjamin. 2013. "The Estate Tax After ATRA." *Tax Notes*. February 25.

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