What's Ahead for Federal Gift Tax?

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-by Neil E. Harl*

Since enactment of the repeal legislation in 2001, the focus has been primarily on the federal estate tax and, to a lesser degree, on the generation skipping transfer tax, with relatively less emphasis on the federal gift tax. Yet the federal gift tax may potentially assume much greater importance if the repeal provisions become reality and the transfer tax system does not revert to its 2001 status, as could well occur.²

It is important to note that December 31, 2009, is now just over three years away.

Review of what was done in 2001

The applicable exclusion amount (which had been expressed as a “unified federal estate and gift tax credit”) was amended with the applicable exclusion amount for federal gift tax purposes “decoupled” from the federal estate tax beginning in 2002.² For federal gift tax purposes, the applicable exclusion amount was set at $1,000,000 and remains there indefinitely unless the “sunset” provision goes into effect.³ At the same time, the federal estate tax applicable exclusion amount was likewise increased to $1,000,000 in 2002 but, unlike the federal gift tax applicable exclusion amount, was boosted to $1,500,000 in 2004, $2,000,000 in 2006 and scheduled for an increase to $3,500,000 in 2009.⁵ Thus, the applicable exclusion amount was “decoupled,” but the calculation of the federal estate tax at death remains coupled.⁶ The gift tax applicable exclusion amount is the amount in effect under I.R.C. § 2010 but determined as if the applicable exclusion amount is $1,000,000.⁷

The top federal estate and gift tax rate (which had been 55 percent for deaths after 1983) (of the excess over $3,000,000 of taxable estate) was reduced beginning in 2002.⁸ The combined rate was reduced to 50 percent for decedents dying and gifts made in 2002, 49 percent in 2003, 48 percent in 2004, 47 percent in 2005, 46 percent in 2006 and 45 percent in 2007 where the rate plateaus until either repeal occurs as to the federal estate tax, the “sunset” provision returns all rates to 2001 levels, additional amending legislation is enacted or, as to the federal gift tax, the rate drops permanently to 35 percent after 2009 (35 percent of the excess over $500,000).⁹ Note that the Congress never anticipated repeal of the federal gift tax and still does not anticipate repeal of the federal gift tax. If the federal estate tax is repealed, the federal gift tax will survive with an applicable exclusion amount of $1,000,000 and a rate of 35 percent (equal to the maximum federal income tax rate). If the “sunset” provision prevails, both the federal estate tax and the federal gift tax will return to an applicable exclusion amount of $1,000,000.

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Congress was advised in early 2001 that repeal of the federal gift tax would seriously jeopardize the revenue stream from the federal income tax.

Because of Congressional fiscal rules, the 2001 Act provided that Chapter 11 of the Internal Revenue Code (federal estate tax) was not to apply to estates of decedents dying after December 31, 2010. The 2001 Act specified that “all provisions of, and amendments made by the Act shall not apply . . . to estates of decedents dying, gifts made or generation skipping transfers after December 31, 2010.” Therefore, all provisions, unless further legislation is enacted amending the provisions, revert to the status of the provisions as of the date of enactment in 2001.

**Effect on income tax basis**

The provision authorizing a new income tax basis at death, which can be up or down from the decedent’s pre-death basis, has generally allowed an income tax basis equal to the fair market value (or value used for federal estate tax purposes) as of the date of death or the alternate valuation date. In a community property state, the surviving spouse’s one-half share of community property held by the decedent and surviving spouse generally is treated as having passed from the decedent and thus has been eligible for a new basis at death. The rule applies if at least one-half of the whole of the community interest is included in the decedent’s gross estate.

Under the 2001 Act, no change was made in the rules governing income tax basis determinations at death until repeal of the federal estate tax, effective for deaths after December 31, 2009. After 2009, recipients of eligible property transferred at the decedent’s death will receive an income tax basis equal to the lesser of the adjusted income tax basis of the decedent or the fair market value of the property at the decedent’s death. Property acquired from the decedent will be treated as if acquired by gift except for an additional allowance (which can be used to increase the pre-death basis but not above fair market value) of $1.3 million per estate, $3 million in addition for a surviving spouse and $60,000 for a non-resident who is not a U.S. citizen. The basis increase amounts are adjusted for inflation for decedents dying after 2010, if carryover basis is still in effect at that time. The $1.3 million amount is increased by the amount of unused capital losses, net operating losses and certain “built-in” losses of the decedent.

**In conclusion**

At the moment, the fiscal condition of the country suggests that complete repeal is unlikely with a compromise expected in 2006 or 2007 based upon an applicable exclusion amount of somewhere in the range of $3 million to $3.5 million per decedent and a tax rate of 15 percent or higher and a new income tax basis at death.

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**Footnotes**


4. Id.


7. Id.


11. EGTRRA of 2001, § 901.

12. I.R.C. § 1014(a).


14. EGTRRA of 2001, § 541, adding I.R.C. § 1014(f) (“This section shall not apply with respect to decedent’s dying after December 31, 2009”).


