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Message from the Chair

George Christopher Wright

It has been a little while. In fact - if memory serves me - 2018 was the last time the Chair penned a message in this space. So, on behalf of the Board of Governors of the Virginia State Bar Section on Taxation, I am pleased to re-introduce our Taxation Law Reporter Newsletter.

I am also pleased to announce the Board of Governors for 2022-2023. Thank you to each of you for giving of your time, talent, and leadership.

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This issue includes four interesting articles we hope you find relevant to your practice. First, my article "The Pass-Through Entity Tax: A SALT Cap Workaround" takes a deep dive into the intricacies of the SALT Cap and how it is impacting taxpayers in high income states. Some states have passed a legislative pass-through workaround to alleviate some of the burdens for taxpayers, including those in Virginia. The article examines this evolving issue in lead-up to the anticipated expiration of the SALT cap in 2025.

With the new year upon us, "A Refresher on the Statute of Limitations for Tax Collections: Federal and Virginia" is a timely read. John P. Morgan of Rees Broome, PC breaks down the statute of limitations under the Federal and Virginia statutes, as well as the exceptions that suspend those limitations. His piece urges practitioners to carefully review their clients' assessment dates before proceedings to collections options.

The aftermath of the COVID-19 pandemic continues to reverberate three years after its onset. The release of Notice 2022-36 ("the Notice") by the IRS earlier this year, provides penalty relief for delayed tax filings due to the pandemic. Brandon Mourges with Crepeau Mourges took a deep dive into the Notice, and highlights how taxpayers and their representatives can maximize penalty relief in "How Taxpayers Can Benefit from Unprecedented Penalty Relief Offered by the Internal Revenue Service."

Sophisticated estate planning starts with the basics and good strategy. Peter Holstead Davies and Jake H. Snow with Davies & Davies offer an estate planning primer in, "Federal Estate and Gift Tax Basics."

Calls to Action:

Our organization thrives from the participation of our dedicated members. The Board of Governors welcomes your participation and engagement in the work we do.

- Do you have an article you would like to publish? We welcome your contributions to future Newsletters, or suggestions for topics and articles.
- Have you considered teaching a CLE course in your area of expertise? We are seeking CLE instructors in a variety of practice areas for the upcoming year.
- Are you looking to get more involved in the Virginia State Bar? Consider joining the Section on Taxation Board of Governors to share your ideas, talents, and leadership as we plan for the future of the organization.

Please contact me to get involved, or with any questions. ◆

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The Pass-Through Entity Tax:
A SALT Cap Workaround

By G. Christopher Wright

Background

The calculation of the federal income tax for individuals allows an itemized deduction for payment of state and local taxes, including income taxes, real property taxes, and personal property taxes.[1] The deduction for state and local taxes has long been an Alternative Minimum Tax ("AMT") adjustment item, meaning that no deduction for state and local taxes is allowed for purposes of the AMT.[2] Generally, only high income taxpayers get caught in the AMT because of the AMT exemption.[3] Consequently, the AMT adjustment for state and local taxes effectively reduces the actual benefit of the deduction for high-income earning taxpayers.

The Tax Cuts and Jobs Act of 2017 ("TCJA") increased the AMT exemption amount and the income phaseout of the exemption, providing some AMT relief for high income taxpayers.[4] However, at the same time, TCJA added § 164(b)(6), placing a $10,000 cap on the total deduction allowed by § 164(a).[5] This cap is commonly referred to as the "SALT Cap". Both the SALT cap and the AMT changes are set to expire at the end of 2025.

The SALT cap has hit taxpayers in high income tax states rather harshly. For example, in California, the individual income tax rates reach 9.55%.[6] Consider, for example, a hypothetical taxpayer filing a joint return with California taxable income of $200,000. The tax owed to California would equal $12,605. Before TCJA, this hypothetical taxpayer would be able to fully deduction the $12,605 as an itemized deduction. During the TCJA SALT cap, this hypothetical taxpayer loses out on a $2,605 federal deduction.

To bypass the SALT cap, several states, including California, have passed legislation allowing an elective "Pass-Through Entity Tax" or "PTET". Generally, income taxes are not imposed at the entity level on a pass-through entity, rather the pass-through entity allocates its income to its owners (partners in the case of a partnership or shareholders in the case of an S-corporation) and the owners report their share of income on their individual federal and state income tax returns and pay the resulting tax. Under § 164(a), the owners would then be allowed an itemized deduction on their federal income tax return for the state income tax they paid on their share of pass-through entity income.

The PTET workaround, however, allows a pass-through entity to make an election to have state income tax imposed at the entity level. The pass-through entity then pays the state income tax and deducts the income tax on its tax return, thus reducing the income it allocates to its owners. Owners of a pass-through entity still report their distributive share of income on their individual state income tax return, but the tax has already been paid by the pass-through entity. The owner will then report a credit for the amount paid on their behalf by the pass-through entity.

For owners of the pass-through entities, the PTET workaround killed two birds with one stone: it beat the SALT cap by allowing a full deduction for state income taxes and it takes the deduction entirely out of the AMT calculation. It sounded almost too good to be true. Would the IRS allow this? The answer is yes, and it came in the form of IRS Notice 2020-75. The IRS unequivocally stated:

> If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made… Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation…For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation.[7]

To date, nearly 22 states have adopted such an elective PTET legislation, including such states as Maryland, California, and New York.[8] Armed with this new strategy, pass-through entities around the country began electing into the new PTET, and entities that were not considered pass-throughs, such as single member LLCs taxed as sole proprietorships, began restructuring their businesses to qualify as a pass-through entity. All seemed right in the world; tax lawyers win again!

Slow Down!

Not so fast said the state of Virginia, and as it turns out quite a few other states. While the PTET workaround plays out nicely for owners of pass-through entities who are residents of PTET states with businesses operating in their state of residence, for example, an owner of a pass-through entity who is a resident of Maryland, what about non-resident owners of pass-through entities with nexus in multiple states? The question was posed by the Virginia Society of CPAs to the Virginia Department of Taxation when the Society asked for a ruling on the "availability of Virginia's credit for taxes paid to another state for taxpayers who are owners of a pass-through entity that makes an election to be taxed at the entity level in Maryland."[9]

In a mixed response to the ruling request, the Tax Commissioner, in Public Document Number: 21-156 (December 29, 2021), held that a credit might be allowed for owners of an S-corporation <u>but not</u> for owners of a partnership. The Commissioner's conclusion is based upon its analysis of the Maryland PTET statute and the text of Va. Code Ann. § 58.1-332.

Virginia Code Ann. § 58.1-332 A states, in part, "Whenever a Virginia resident has become liable to another state for income tax on any earned or business income…for the taxable year, derived from sources outside the Commonwealth and subject to taxation under this chapter, the amount of such tax payable by him shall, upon proof of such payment, be credited on the taxpayer's return with the income tax so paid to the other state."[10]

However, § 58.1-332 C states, "For purposes of this section, the amount of any state income tax paid by an electing small business corporation (S corporation) shall be deemed to have been paid by its individual shareholders in proportion to their ownership of the stock of such corporation."[11]

Turning to the Maryland statute, the Commissioner analyzed Maryland § 10-102.1.[12] The Commissioner stated: "If the PTE chooses to be taxed at the entity level, it pays tax on the distributive or pro rata share of all members. The individual members may then claim their share of the tax paid by the PTE on their Maryland individual income tax returns. Maryland law expressly provides that when the PTE makes the election, the tax is treated as a tax imposed on the PTE itself. See *Md. Code Ann.* § 10-102.1(c)(3)."[13] That section states: "With respect to a pass-through entity that pays the tax imposed …the tax shall be treated as a tax imposed on the pass-through entity itself.[14]

The phrase "tax imposed on the…entity itself" was outcome determinative. The Virginia regulation at 23 VAC 10-110-221 specifically states that "A credit may not be claimed by an individual for *tax imposed by another state on a distributing entity* e.g., an estate, regulated investment company, a partnership or a trust in which the individual is a beneficiary or shareholder."[15]

Lastly, the Commissioner's opinion relies on the Latin maxim: e*xpressio unius est exclusio alterius*; which translates into "the expression of one thing is the exclusion of the other."[16] Consequently, since § 58.1-332 C expressly states that a credit is allowed for taxes imposed on an S corporation but is silent as to other types of entities, then all entities that are not S corporations are excluded from receiving similar treatment.

What's a partner to do?

Legislative fix to the rescue. Giving a nod to possible solution in the opinion, the Commissioner cited *Howell's Motor Freight, Inc. v. Virginia Dep't of Tax'n*, 1 Va. Cir. 382 (1983), in which the court ended its opinion stating "[p]laintiffs have made out a strong case for legislative reform."[17]

To show you how fast things can change in the tax world, I proposed the idea for writing this article on February 3rd, roughly three weeks after legislation addressing this issue was introduced in both the House and Senate of Virginia. The final act was signed into law on April 11.[18]

The Virginia Department of Taxation released Tax Bulletin 22-6 on April 15, 2022, outlining the two goals accomplished by the new legislation.[19] First, Virginia enacted its own version of the pass-through entity tax.[20] Second, it provided the legislative fix needed to reverse the Commissioner's holding in Public Document 21-156 regarding the out-of-state tax credit issue discussed above.[21]

HB 1121 modified § 58.1-332 C as follows (italicized items are the changes):

> C. *1.* For purposes of this section, the amount of any state income tax paid by an electing small business corporation (S corporation) shall be deemed to have been paid by its individual shareholders in proportion to their ownership of the stock of such corporation.
>
> *2. For taxable years beginning on and after January 1, 2021, but before January 1, 2026, for purposes of this section, the amount of any state income tax paid by a pass-through entity under a law of another state substantially similar to § 58.1-390.3 shall be deemed to have been paid by its individual owners in proportion to their ownership.*

As a result, so long as the out-of-state pass-through entity tax law is "substantially similar to § 58.1-390.3," then the Virginia resident will receive a credit for income tax paid by the out-of-state pass-through entity. The Virginia Tax Bulletin 22-6 states that the implementation of new provision regarding credits is available immediately in tax year 2021.

Notably, Virginia's pass-through entity tax election and the available credit for state income tax paid by an out-of-state pass-through entity both expire at the end of 2025, the same year that the SALT cap under TCJA is set to expire. Maryland's pass-through entity tax under § 10-102.1 does not have a similar expiration, consequently, this issue will resurface for Virginia taxpayers in 2026.

Conclusion

Virginia partners and shareholders of pass-through entities now have available options to deal with the TCJA SALT cap, albeit these options, at the moment, are temporary. The expiration date on § 58.1-332 C.2 makes long-term tax planning difficult, if not impossible. Lawyers who advise pass-through entity clients on taxes will have to continue to keep track of this evolving area of the law. ◆

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Endnotes

1 IRC § 164(a)(1)-(3).
2 § 56(b)(1(A)(ii).
3 § 55(d)(1).
4 § 55(d)(4). The Act increased the income phaseout from $150,000 to $1,000,000 for a joint return.
5 IRC § 164(b)(6).
6 Cal. Rev. & Tax. Code § 17041(h).
7 IRS Notice 2020-75
8 https://perma.cc/BAV6-5TNB (last visited April 30, 2022).
9 Tax Commissioner Document Number 21-156.
10 Va. Code Ann. § 58.1-332 A.
11 Id. at § 58.1-332 C.
12 Md. Tax-General Code Ann. § 10-102.1
13 Public Document 21-156 (December 29, 2021).
14 Md. Tax-General Code Ann. § 10-102.1
15 Virginia Administrative Code, 23 VAC 10-110-221.
16 Black's Law Dictionary (11th ed. 2019).
17 *Howell's Motor Freight, Inc. v. Virginia Dep't of Tax'n*, 1 Va. Cir. 382 (1983).
18 See HB 1121 and SB 692.
19 Virginia Tax Bulletin 22-6 (April 15, 2022).
20 Va. Code Ann. § 58.1-390-3.
21 Va. Code Ann. § 58.1-332 C.2.

A Refresher on the Statute of Limitations for Tax Collections:

Federal and Virginia

By John P. Morgan, JD, CPA, LLM, CFP® | Rees Broome, PC | Tysons Corner, VA

Just as the IRS and local tax authorities do not have an unlimited period of time to assess against taxpayers, the IRS and local tax authorities have a limited period of time to collect taxes that have been assessed. Readers of this publication practice in Virginia; accordingly, this article provides information about the collection statute in Virginia in addition to the Federal collection statute.

Federal Statute of Limitations

Section 6502 of the Internal Revenue Code provides, generally, a ten-year statute of limitations for the IRS to collect assessed taxes by means of levy or a proceeding in court.[1] This statute of limitations applies to *any* tax imposed by the Internal Revenue Code.[2] Additionally, if the taxpayer has an installment agreement in place with the IRS, then collection efforts through levy or court proceeding must take place within ninety days after the expiration of any collection period agreed upon in writing by the IRS and the taxpayer at the time the installment agreement was entered.[3] Further, if a timely court proceeding to collect tax is commenced, then the period to collect taxes by levy is extended and will not expire until the liability for such tax is satisfied or becomes unenforceable.[4]

Certain actions that prohibit the IRS from collecting by levy or in court will suspend the running of the period of limitation.[5] Among these actions are a pending offer in compromise, an installment agreement, military deferment, bankruptcy, and IRS litigation.[6] A notable omission from this list is a taxpayer being placed on Currently Not Collectible (CNC) status, which does not suspend the collection statute.

The statute of limitations does not run while a taxpayer's assets are in control or custody of the court,[7] or when a taxpayer is outside of the United States for at least six continuous months.[8] Specific to assessed estate taxes, if an executor is granted an extension of time to pay estate tax, then the collection statute is suspended during such time.[9]

The IRS has at its disposal additional opportunities to extend the time to collect assessed taxes. Under 28 USC § 3201, the government may reduce a tax lien to judgment. A judgment lien created under this statute extends a lien for a period of twenty years in addition to the lien created by IRC Section 6502.[10] Even the initial 28 USC § 3201 lien may be renewed for an *additional* twenty years (provided that the notice of lien renewal is filed before the expiration of the initial twenty-year judgment lien period and the court approves lien renewal), bringing the total period of time to collect an assessed tax to fifty years.[11]

The IRS does not exercise its authority to reduce every federal tax lien to judgment. Doing so is time-consuming and expensive; the IRS is more likely to pursue a judgment for significant tax assessments. It remains to be seen whether the monetary allocations to the IRS for tax enforcement associated with the Inflation Reduction Act results in more judgment liens being filed against taxpayers.

In the author's recent experience, when a statute of limitations has expired for collection of taxes, the IRS automatically removes the expired liability from a taxpayer's account transcript.

Virginia Statute of Limitations

Section 58.1-1802.1 of the Virginia Code generally provides a seven-year statute of limitation for Virginia to collect assessed taxes by levy, court proceeding, or other means available to the Virginia Tax Commissioner under Virginia law. For assessments made on or after July 1, 2016, all collection efforts are to cease after the seven-year period following assessment, *even if* collection efforts were initiated within the seven-year period.[12]

As is the case with the federal statute of limitations on collection, Virginia provides several situations in which the statute of limitations is suspended. Virginia law provides that the running of the statute is suspended during the period for which a taxpayer's assets are in the custody of any state or federal court (including Bankruptcy Court), when the taxpayer is outside of Virginia for a period of at least six continuous months, and during such time that an installment agreement to pay Virginia taxes is in effect.[13]

Prior to the collection statute expiring, the Virginia Tax Commissioner and taxpayer may agree to extend the period of time to collect assessed taxes.[14] Virginia law also affords the Commonwealth the opportunity to extend a statute of limitations by filing a lien memorandum.[15] The Virginia statute of limitations on collections expressly does not apply to limitations on the enforcement of judgments under Virginia Code Section 8.01-251. This statute provides that for judgments dated on or after July 1, 2021, "[n]o execution shall be issued and no action brought on a judgement… after ten years from the date of such judgment."[16] Further, the Commonwealth may extend the ten-year enforcement period on a judgment by extending the limitation of the right to enforce its judgment lien by recording a statutory certificate prior to the expiration of the initial ten-year period.[17] Thereafter, the Commonwealth may record *one* additional extension by recording another extension certificate before the expiration of the original ten-year extension, which extends the limitations period for another ten years from the date the second certificate is recorded.

In summary, Virginia, through its various means of extending time, may avail itself of a thirty-seven-year period of time to collect assessed taxes, in contrast to the IRS's fifty-year period.

In the author's recent experience, the Virginia Department of Taxation does *not* automatically remove tax liabilities for which the collection statute has expired from a taxpayer's account. Instead, taxpayers (or their practitioners) will need to write to the Virginia Department of Taxation requesting removal. It is therefore critical that practitioners receive data about their client's dates of assessments and carefully review whether the Virginia Department of Taxation is approaching, or has passed, its statute of limitations to collect.

Conclusion

Practitioners should always bear in mind that an assessment of tax made against their clients does not mean that the inquiry as to whether a liability will be paid is over. Before proceeding on collection alternatives such as offers in compromise or installment agreements, practitioners should verify the dates of assessment made against their clients and determine whether statutes of limitations have expired or will be expiring in the near future. A pending statute expiration could lead a practitioner to determine that a different course of action is in the best interests of their clients. ◆

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Endnotes

1 The IRS's statute of limitations on assessing taxes can be found in IRC § 6501. An analysis of the rules regarding this statute is beyond the scope of this article.
2 IRC § 6502(a).
3 IRC § 6502(a)(2).
4 *Id.*
5 IRC § 6503(a)(1).
6 IRM § 5.1.19.2.2(2).
7 IRC § 6503(b).
8 IRC § 6503(c).
9 IRC § 6503(d).
10 28 USC § 3201(c)(1).
11 28 USC § 3201(c)(2).
12 Va. Code Ann. § 58.1-1802.1(A).
13 Va. Code Ann. § 58.1-1802.1(B).
14 Va. Code Ann. § 58.1-1802.1(A).
15 Va. Code Ann. § 58.1-1805(A). The lien memorandum should be filed in the clerk's office of the circuit court in which a taxpayer's business (if business taxes have been assessed) is located or in which the taxpayer resides. If a taxpayer has no business or residence in the Commonwealth, then the memorandum can be filed in the Circuit Court of the City of Richmond.
16 Va. Code Ann. § 8.01-251(A). For judgments dated, extended, or renewed prior to July 1, 2021, the applicable period is 20 years rather than 10 years. *Id.*
17 Va. Code Ann. § 8.01-251(B). The statutory certificate can be found in Va. Code Ann. § 8.01-251(G).

Notice 2022-36:

How Taxpayers Can Benefit from Unprecedented Penalty Relief Offered by the Internal Revenue Service

By Brandon Mourges

On August 24, 2022, the Internal Revenue Service released Notice 2022-36 ("the Notice"),[1] which provided broad-based penalty relief for many tax filing delinquencies that occurred during the COVID-19 pandemic. Taxpayers, as well as their representatives, need to understand the coverage and benefits of the Notice as it can have a significant impact on the resolution of outstanding tax liabilities.

The Notice exclusively provides relief for failure to file penalties and similar delinquency-related penalties for returns for the 2019 and 2020 tax years.[2] In particular, with respect to income tax returns, the Notice offers nearly across-the-board relief for failure to file penalties related to Forms 1040 (individual income tax returns), Forms 1120 (corporate income tax returns), and Forms 1041(income tax return for estates and trusts), as well as other specified returns; however, to qualify for such relief, taxpayers must file those returns no later than September 30, 2022. So long as the failure to file is not due to fraud, affected taxpayers will not be required to establish reasonable cause or otherwise apply for administrative waiver – the relief will be automatically granted.[3]

Aside from income tax returns, the Notice also provides automatic relief from certain penalties associated with delinquent information returns. In particular, the Notice applies to delinquent Forms 3520 (information returns for certain foreign trusts and gifts), Forms 5471 (information returns for certain foreign corporations), Forms 1065 (partnership tax returns), Forms 1120-S (S-corporation tax return), and other information returns (such as Forms W-2 and Forms 1099).[4] While most of those returns need only be filed on or before September 30, 2022 to qualify for relief, delinquent returns that would potentially be subject to penalties under I.R.C. § 6721(a)(2)(A) – like Forms W-2 and Forms 1099 – need to have been filed by August 1 of the year when they were due. (For instance, Forms W-2 for the 2019 tax year that were due to be filed on January 31, 2020 must have been filed by August 1, 2020 to qualify for relief.)

While the relief offered by the Notice is significant, there are many points that need to be remembered. First and foremost, taxpayers need to meet the eligibility criteria and file applicable returns by the dates stated in the Notice. Given the current issues facing the Internal Revenue Service and significant processing delays, taxpayers would be well-advised to keep records of mailing and filing. Taxpayers should also endeavor to file these returns as far in advance of the September 30, 2022 deadline as possible. (Since the "mailbox rule" only generally deems the mailing date as the filing date when the mailing is "timely," it is not clear how that general rule might be applied in this situation.[5]) Second, taxpayers must understand that this relief only applies to failure to file penalties for tax returns. It will not result in abatement of failure to pay penalties or accuracy-related penalties. It does not apply to delinquent employment tax returns (Forms 941) or unemployment tax returns (Forms 940). On the other hand, taxpayers should still be able to raise arguments like reasonable cause to challenge those penalties and might cite the rationale of the Notice in support of their abatement request. Moreover, taxpayers are not eligible if the failure to file was done for some fraudulent purpose.[6] Third, taxpayers should understand how the relief works within the context of other available programs and their overall tax situation. The relief should be automatic and taxpayers will receive corresponding reductions to balances due or refunds of amounts already paid; however, it is not clear how long relief will take and there are bound to be administrative errors.[7] Those taxpayers currently seeking to resolve their liabilities through a collection alternative may need to re-visit their strategy in light of these changes. Taxpayers may also wish to re-consider whether to submit information returns through the Delinquent Information Return Submission Procedures or other compliance programs in light of this guidance.[8] And employers who filed late Forms W-2 or other forms may want to raise the Notice if they were subject to a correspondence audit.

In sum, Notice 2022-36 is a welcome relief to many taxpayers that were unable to timely file a host of tax returns as a result of the COVID-19 pandemic. To maximize the benefits and ensure proper application of this relief, taxpayers with delinquent returns for the 2019 and 2020 tax year should review their tax situation with a professional as soon as possible. ◆

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Endnotes

1 Notice 2022-36, Penalty Relief for Certain Taxpayers Filing Returns for Taxable Years 2019 and 2020, *available at:* https://www.irs.gov/pub/irs-drop/n-22-36.pdf (last accessed August 30, 2022).

2 Pursuant to I.R.C. § 6651(a)(1), a penalty of five percent per month (up to a maximum of twenty-five percent) applies to the amount of any underpaid income tax.

3 *See, e.g.,* Treas. Reg. § 301.6651-1(c)(1) (explaining reasonable cause for delinquency penalties); Internal Revenue Manual 20.1.1.3.3.2.1 (10-19-2020) (explaining the Internal Revenue Service's First Time Abate policy).

4 Each information return is generally subject to a different statutory penalty regime. For partnership tax returns and S-corporation return, the penalty is typically the product of the number of owners, the number of months a return is delinquent, and the statutory rate. *See* I.R.C. § 6698 (for partnership tax returns); I.R.C. § 6699 (for S-corporation returns). For international information returns like the Form 3520 and Form 5471, the penalty is typically a function of a percentage of a certain transaction amount or statutory penalty amount multiplied by the number of months a return is delinquent. *See, e.g.,* I.R.C. § 6039F (penalty for failure to report large foreign gift); I.R.C. § 6038C (failure to furnish information on foreign corporation). Finally, with respect to Forms W-2 or Forms 1099, the penalty is typically the product of the number of information returns (i.e., payees) multiplied by the statutory penalty amount. *See, e.g.,* I.R.C. § 6721(a)(1) (imposition of penalties for failure to furnish).

5 *See* Treas. Reg. § 301.7502-1(a) (explaining that "timely mailed" is "timely filed;" however, untimely mailing does not generally cause a filing date to relate back to the date of mailing).

6 *See* Notice 2022-36 (explaining that relief does not apply if the return would be subject to a penalty under I.R.C. § 6651(f) (fraudulent failure to file) or I.R.C. § 6663 (accuracy-related fraud penalty)).

7 Notice 2022-36 specifically references the substantial administrative issues facing the Internal Revenue Service. Numerous articles report the continuing significant backlog of the Internal Revenue Service in processing various tax returns and handling taxpayer phone calls.

8 This is merely an example of one resolution program that may be impacted by Notice 2020-36. More information on programs such as the Delinquent International Information Return Submission Procedures, Streamlined Filing Compliance Procedures, and other programs are available online at irs.gov.

Federal Estate and Gift Tax Basics

By Jake H. Snow and Peter Holstead Davies

This article provides an introduction to basic concepts of federal estate and gift taxation for practitioners unfamiliar with the area.

Federal law imposes transfer taxes on an individual's gratuitous lifetime transfers and deathtime transfers in the form of estate taxes, gift taxes, and generation-skipping transfer taxes.[1]

Together, these topics form an area of law ripe with planning opportunities and pitfalls.

A few general principles are relevant to both estate and gift tax:

First, these transfer taxes are imposed on the value of the property being transferred, after applicable exclusions, deductions, and credits. The estate tax is imposed on the fair market value of the decedent's estate at the time of the decedent's death.[2] The gift tax is imposed on the value of the gifted property as of the date of the gift.[3]

Second, the estate tax and gift tax are both computed using the same rate schedule.[4] The rate schedule is graduated, starting at 18 percent and topping out at 40 percent.

Third, the estate tax and gift tax regimes share a unified credit, which may be applied to gift taxes, estate taxes, or a combination of the two.[5] Use of the unified credit for gift tax owed by the taxpayer reduces the amount of the credit available to be applied to estate taxes owed by the taxpayer's estate. In theory, the multi-use rate schedule and the unified credit mean that a transfer during the taxpayer's lifetime of $X results in the same transfer tax liability of a deathtime transfer of $X. In practice, many advisors utilize various planning tools to maximize the economic efficiency of wealth transfers, such that the economic value of a lifetime transfer and a deathtime transfer are not necessarily equal. These planning tools are beyond the scope of this article.

SECTION ONE: Federal Estate Tax

Determining the Gross Estate

The federal estate tax is a tax on the transfer of a decedent's taxable estate.[6] To determine the value of the decedent's taxable estate, the value of the decedent's gross estate must be determined.[7] The rules for determining the value of the decedent's gross estate are described in Sections 2031 through 2046 of the Code. Section 2031(a) sets forth the general rule: "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."[8]

Careful study of sections 2031 through 2046 is warranted, as the gross estate includes those property interests held by the decedent at the time of death[9] *and* certain property interests that were not held by the decedent at the time of death.[10] For example, if the taxpayer completes a lifetime gift, the gifted property is not a part of the taxpayer's estate for estate and trust administration purposes under Virginia law. Nonetheless, if the taxpayer completes a lifetime gift of property within three years of the date of the taxpayer's death, and that property would have been includable in the taxpayer's estate under section 2036, 2037, 2038, or 2042, the value of that property is included in the value of the taxpayer's gross estate.[11] Likewise, though holding a general power of appointment is not the same thing as holding title to property under Virginia law, a taxpayer who holds a general power of appointment over property on the taxpayer's date of death has the value of that property included in the value of the taxpayer's gross estate under § 2041(a)(2).[12]

Calculating the Taxable Estate and Tentative Tax, Pre-Credits

Once the value of the gross estate has been determined, the value of the taxable estate can be calculated.[13] The value of the taxable estate is calculated by subtracting the applicable deductions provided for in Sections 2051 through 2058 from the value of the gross estate. Commonly used deductions include deductions for expenses, indebtedness, and taxes;[14] charitable deductions;[15] and the marital deduction.[16] Once the applicable deductions have been applied, the value of the taxable estate is known, and computation of the tentative tax owed may begin.

To determine the tentative tax owed, first calculate the amount with respect to which the tentative tax is to be computed; then apply that amount to the rate schedule.[17] First, combine the value of the taxable estate with the amount of the adjusted taxable gifts (other than those included in the gross estate) and subtract the amount of gift tax which would have been payable at the time of those gifts, subject to the adjustments set forth in Section 2001(g).[18]

Apply the resulting amount to the rate table in Section 2001(c).[19]

Applying Credits Against the Tax

Finally, the tentative tax is reduced by any credits against the tax. The primary credit to consider is the unified credit.[20] The unified credit is calculated by reference to the basic exclusion amount, as adjusted for inflation,[21] and in the case of a surviving spouse, the deceased spousal unused exclusion amount.[22] For decedents dying in 2022, the inflation adjusted basic exclusion amount is $12,060,000.[23] For decedents dying in 2023, the inflation adjusted basic exclusion amount is $12,920,000.[24] The deceased spousal unused exclusion amount allows the second-to-die spouse's estate to make use of the first-to-die spouse's unused exclusion.[25] Other credits are available for certain gift taxes paid[26] and, in some instances, for estate taxes previously paid.[27] It's important to note – the unified credit referred to in this paragraph is the same unified credit referred to in the introductory section of this article. Therefore, two decedents with identical estates and identical dates of death may owe different amounts of estate tax if one decedent used more of the unified credit on taxable gifts than the other.

SECTION TWO: The Federal Gift Tax

The federal gift tax, imposed by § 2501,[28] is a tax on the donor's taxable gifts in the calendar year.[29] A donor's taxable gifts are "the total amount of gifts made during the calendar year, less the deductions provided in subchapter C."[30]

The Annual Exclusion and other Caveats

In calculating the total amount of gifts made during the calendar year, § 2503(b) provides for an annual exclusion. The first $10,000 (adjusted for inflation)[31] of gifts (other than future interests in property) made to any person are not included in the total amount of gifts made during such year.[32] For 2022, the amount of the annual exclusion is $16,000.[33] For 2023, the amount of the annual exclusion is $17,000.[34] Section 2503 also provides an exclusion for qualified transfers of tuition and payment for medical care.[35] Many taxpayers make use of these exclusions to make lifetime transfers to the eventual beneficiaries of their estate. Doing so allows the gifts to pass to the beneficiaries free of gift tax, and, if the transfer escapes the reach of § 2035, reduces the size of the decedent's gross estate, thereby reducing estate tax liability.

If a gift does not meet the criteria for one of the exclusions named above, there may be a deduction available to the donor. Section 2522 allows a charitable deduction for gifts made to qualifying charitable organizations,[36] and Section 2523 allows a marital deduction for gifts between spouses.[37]

Calculating the Gift Tax

Once the applicable exclusions and deductions have been applied, the value of the donor's taxable gifts for the calendar year are known. The gift tax owed is calculated in a two-step process with reference to the rate schedule set forth in § 2001(c). In the first step, the aggregate sum of the taxable gifts for such calendar year and for each of the preceding calendar periods is used to calculate a tentative tax under § 2001(c). In the second step, the aggregate sum of the taxable gifts for each of the preceding calendar periods is used to calculate a tentative tax under § 2001(c). The tax imposed by § 2501 is the excess of the tentative tax from step-one over the tentative tax from step-two.[38] Then, if it has not already been used, the unified credit may be applied to any gift tax owed. For gift tax purposes, the unified credit is (1) "the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by (2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods."[39]

CONCLUSION

As previously mentioned, this article is intended to be a brief primer on estate and gift tax concepts. It does not cover generation-skipping transfer tax, but practitioners should be aware that the generation-skipping transfer tax is also often present in these scenarios. With exclusion amounts at historic highs, these tax regimes are inapplicable to many taxpayers. For those clients with transfer tax concerns, the financial stakes often warrant sophisticated estate plans with detailed gifting strategies. The sheer volume of wealth involved in taxable transfers makes the planning opportunities double-edged swords: if done properly, a good estate plan can provide tremendous value by maximizing the amount of property that passes to intended beneficiaries; if done improperly, a poor estate plan can produce severe tax liability. ◆

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Endnotes

1 The generation-skipping transfer (GST) tax was covered in a recently published article in the Summer 2022 Virginia Trusts & Estates Newsletter. Cynthia L. Brown, *The ABCs of GST*, 25 Trusts & Estates Newsletter 3, at page 2.
2 26 U.S.C. § 2031; 26 C.F.R. § 20.2031-1(b). An executor may also elect an alternate valuation method under 26 U.S.C. § 2032.
3 26 U.S.C. 2512(a).
4 26 U.S.C. § 2001(c).
5 *See* 26 U.S.C. § 2010; 26 U.S.C. § 2505.
6 26 U.S.C. § 2001(a).
7 26 U.S.C. § 2051.
8 26 U.S.C. § 2031(a).
9 26 U.S.C. § 2033.
10 26 U.S.C. § 2035.
11 *Id.*
12 26 U.S.C. § 2041(a)(2).
13 26 U.S.C. § 2051.
14 26 U.S.C. § 2053.
15 26 U.S.C. § 2055.
16 26 U.S.C. § 2056.
17 26 U.S.C. § 2001(b); 26 U.S.C. § 2001(c).
18 26 U.S.C. § 2001(b); 26 U.S.C. § 2001(g).
19 26 U.S.C. § 2001(c).
20 26 U.S.C. § 2010.
21 *See* 26 U.S.C. § 2010(c)(3)(B). Although 26 U.S.C. § 2010(c)(3)(A) sets the basic exclusion amount at $5,000,000 for decedents dying or gifts made after December 31, 2017, and before January 1, 2026, $10,000,000 shall be substituted for $5,000,000. *See* 26 U.S.C. § 2010(c)(3)(C).
22 26 U.S.C. § 2010(c)(2)(B).
23 Rev. Proc. 2021-45, 2021-48 I.R.B. 764 (Nov. 10, 2021).
24 Rev. Proc. 2022-38 (Oct. 18, 2022).
25 26 U.S.C. § 2010(c)(4); 26 U.S.C. § 2010(c)(5). Making use of the first-to-die spouse's unused exclusion requires timely election on the estate tax return of the estate for the first-to-die spouse.
26 26 U.S.C. § 2012.
27 26 U.S.C. § 2013; 26 U.S.C. § 2014.
28 26 U.S.C. § 2501.
29 26 U.S.C. § 2502.
30 26 U.S.C. § 2503(a).
31 26 U.S.C. § 2503(b)(2).
32 26 U.S.C. § 2503(b)(1).
33 Rev. Proc. 2021-45, 2021-48 I.R.B. 764 (Nov. 10, 2021).
34 Rev. Proc. 2022-38 (Oct. 18, 2022).
35 26 U.S.C. § 2503(e)(2).
36 26 U.S.C. § 2522.
37 26 U.S.C. § 2523.
38 26 U.S.C. § 2502(a).
39 26 U.S.C. § 2505(a)(1); 26 U.S.C. § 2505(a)(2).

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