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federal estate and gift taxes

What recent tax law changes mean and how to take advantage of them in planning family estates

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contents

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federal estate and gift taxes

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Most families want to keep property transfer taxes (estate and gift taxes) as low as possible. This is a common objective in planning family estates. At your death, the transfer of your property (your estate) to others is subject to the federal estate tax.[1] If you make gifts to someone during your lifetime, these transfers also are subject to a tax — the federal gift tax. Each tax has slightly different rules, so you need to understand both the state and the federal tax provisions when planning your estate.

The Tax Reform Act of 1976 made substantial changes in the federal estate and gift tax law. The reform had the effect of drastically narrowing the advantage of some common estate-planning tools and has brought relief to small and moderately sized estates. This bulletin explains the provisions of the revised federal estate and gift tax law and provides planning pointers to manage the tax.

federal estate tax

The federal estate tax is an excise tax. It is levied upon the transfer of your property at death. The tax applies to the total estate being transferred, after allowing for deductions and credits against the estate. The amount of the tax is not affected by the relationship of the beneficiary to you, except for a marital deduction, which is a special deduction for a surviving spouse. Whether your estate will pay a federal estate tax depends upon the estate size and the amount of deductions and credits available for your estate. This understanding starts with calculating the value of your gross estate.

Gross estate

The value of the gross estate includes the fair market value of all property owned by the deceased and all property in which the deceased had an economic interest even though outright ownership had been transferred to someone else prior to death. Examples of economic interest are the retained right to the income from property, the right to change who inherits the property and the right to change the future use or enjoyment of the property.

All property in the gross estate is appraised at its fair market value at the date of death or six months after the date of death. The estate representative, executor or administrator can choose the valuation date. Many factors such as market activity, local sales, rentals and expert testimony are taken into consideration when arriving at the fair market value. The only exception to valuation of property at the fair market value is the valuation of certain real property, which is discussed on page 8.

Kinds of ownership

The following list discusses specific kinds and ownership patterns of property which are included in the gross estate.

1. **Sole ownership** applies to property owned by one person only — the deceased. During lifetime, that person had absolute ownership rights to sell, deed, mortgage or otherwise dispose of the property so held (except for a married man whose interest is subject to special rights for his widow). The entire value of solely owned property is part of the gross estate.

2. **Tenancy-in-common** exists when two or more persons each own an undivided share in property. Each tenant has the right to mortgage, sell, assign or convey his undivided share. At death, a tenant's fractional interest share in the property is included in the gross estate; for example — if two individuals own equal shares in farmland, only one-half the value of the farm is included in the deceased tenant's gross estate.

3. **Joint tenancy with rights of survivorship** exists when two or more persons own an undivided share in property together. Jointly, the tenants have the right to mortgage, sell, assign or convey their owner-

[1] *Transfers at death are also subject to the Michigan Inheritance tax, but this Michigan tax is not discussed in this bulletin.*

ship rights. At the death of a joint tenant, the federal estate tax law assumes that the decedent provided all the consideration (had paid for the property); therefore, the entire value of the jointly held property is included in the decedent's estate. If the surviving joint tenant(s) were financially responsible for the acquisition and payment of all or part of the property, and this contribution can be proven, then a portion of the property value may be removed from the decedent's estate. If the joint tenants did not purchase the property, but obtained the property as a gift or inheritance from third parties, then the decedent's share of ownership in the jointly held property is included in the gross estate.

4. **Tenancy by the entirety** is a special type of joint tenancy with rights of survivorship between husband and wife. At the death of one of the joint tenants, the "consideration-furnished" test (discussed later) holds for the amount of property included in the estate, except in those cases where the parties have equalized the contributions under the "fractional interest rule for spouses." This rule is discussed in a later section.

5. **Life insurance** proceeds are part of the gross estate if the decedent retained any of the "incidents of ownership" in the policy on his life, even though the proceeds are paid to a named beneficiary. "Incidents of ownership" include the right to change beneficiaries, surrender the policy for cash, cancel, borrow against the policy reserves, pledge the policy as collateral for a loan or to assign the policy to another. The insurance proceeds are included in the gross estate even if not owned by the decedent but paid to the decedent's estate.

6. **Gifts within 3 years of death** are included in the gross estate if the gifts exceed the $3,000 annual exclusion (discussed later under the federal gift tax) and are made after 1976. Gifts prior to 1977 and within three years of death are only included in the gross estate if the gift was made in "contemplation of death." The motivation for gifts must be shown for pre-1977 gifts.

7. **Retained life estates** or other lifetime transfers whereby a person transfers property by gift and retains possession, enjoyment or right to income from the property are included in the gross estate. A similar result occurs if the decedent had the right to designate the persons who shall possess the property or receive the income from the property. Transfers intended to take effect at death are also included in the gross estate.

8. **Annuities** are included in the gross estate to the extent payments are made to surviving beneficiaries by reason of the beneficiary surviving the decedent. Annuities purchased through "qualified employees' benefit plans" and after 1976, HR 10, Keogh retirement plans and individual retirement accounts (IRA), may be partially included in the gross estate or excluded from the gross estate, depending upon the type and terms of the annuity. Self-employment individual retirement plans are discussed in a later section.

If you have an annuity payable to heirs through your employer, find out from your employer what type it is and determine whether it is a "qualified employees' benefit plan." These plans may be partially excluded from the gross estate. In general, all other types of annuities are included in the gross estate.

Adjusted gross estate

From the gross estate, the following items are deductible in determining the adjusted gross estate:

1. funeral expenses
2. estate administration expenses (legal fees, executor's fees, probate court costs)
3. losses incurred through casualty or theft during administration
4. debts of the decedent and enforceable claims against the estate, and
5. mortgages and liens.

Taxable estate

From the adjusted gross estate, the following items are deductible in determining the taxable estate:

1. a marital deduction for qualifying property passing to the decedent's spouse equal to the greater of one-half the decedent's adjusted gross estate or $250,000
2. the value of property transferred to or for the use of charitable, educational, religious or public institutions or to the government, and
3. an orphan's exclusion, which is $5,000 multiplied by the difference between age 21 and each orphan child's age.

A tentative tax is calculated from the taxable estate. Then, a unified credit is subtracted from the tentative tax.

In addition to the unified credit, credits are allowed against federal estate taxes for:

— Michigan inheritance taxes

— federal gift taxes paid on lifetime transfers **before** 1977 which are included in the gross estate, and

— federal estate taxes paid by prior estates on previous transfers to the decedent.

For most Michigan estates, the most commonly applicable credit is the unified credit and the credit for Michigan inheritance taxes.

federal gift tax

Like the federal estate tax, the gift tax is an excise tax levied upon transfers of property made "without adequate and full consideration," i.e., transfers made without the receiver paying for the property. It is levied upon transfers by gift during the giver's lifetime. Before the gift tax is calculated, the donor (giver) may deduct from the value of the gift:

1. **An annual exclusion of the first $3,000 in gifts** made to any one donee or recipient, provided the gifts are not of "future interest."

   A gift of future interest is one which the donee (recipient) will not use, possess or enjoy until some future date. This "future interest" exception to exclusion is prompted by the belief that a gift of future interest is more like a testamentary distribution of property (i.e., an item in a will) than a current small gift. A married donor may elect with the spouse to treat all gifts made by either as being one-half from each. This has the effect of doubling the annual exclusion.

2. **A marital deduction for property transferred to the spouse.**

   A donor is allowed an unlimited marital deduction for the first $100,000 of lifetime gifts made to a spouse, no exemption for the next $100,000 and thereafter a deduction for one-half of the aggregate lifetime gifts made to a spouse in excess of $200,000.

3. **Transfers for public, charitable and religious use.**

4. **Any items which tend to reduce the net value of gifts** such as partial payment, mortgages and other charges against the specific property transfers.

A tentative gift tax is calculated from taxable gifts, using the unified rate schedule. The unified credit is subtracted from the tentative gift tax before gift taxes are paid. A gift tax is paid only if the unified credit has been used for prior gifts.

unified credit and rate

Before the Tax Reform Act of 1976, the federal estate and gift tax had separate rate schedules, and the two taxes were separately administered, depending upon whether they were lifetime gifts or death transfers. The 1976 law provides a single, unified rate schedule for estate and gift taxes, and the same rate schedule is used for lifetime gifts or death transfers. The rates are progressive, starting at 18 percent and increasing to 70 percent for cumulative taxable transfers in excess of $5 million (Table 1).

Notice in Table 1 that the tax rate is graduated. The tentative tax rate on the first $10,000 of the taxable estate or lifetime gifts is 18%. The taxable estate or lifetime gifts from $10,000 to $20,000 will result in a tax of $1,800 on the first $10,000 of property transferred and a 20% tax rate for a transfer of more than the first $10,000, but less than $20,000. For example, for a taxable estate of $110,000, line 7 in the table (taxable estate from $100,000 to $150,000) shows the tentative tax on the first $100,000 to be $23,800 and the tax on the next $10,000 would be $3,000 ($10,000 × 30% = $3,000). The total tentative tax, therefore, on a $110,000 transfer would be $23,800 plus $3,000 or $26,800.

Table 1 — Federal Estate and Gift Tax Rate Schedule.

	Taxable estate and lifetime gifts From:	To:	*Tax* $ +	%	*Of excess over:*
1	$ 0	$ 10,000	$ 0	18	$ 0
2	10,000	20,000	1,800	20	10,000
3	20,000	40,000	3,800	22	20,000
4	40,000	60,000	8,200	24	40,000
5	60,000	80,000	13,000	26	60,000
6	80,000	100,000	18,200	28	80,000
7	100,000	150,000	23,800	30	100,000
8	150,000	250,000	38,800	32	150,000
9	250,000	500,000	70,800	34	250,000
10	500,000	750,000	155,800	37	500,000
11	750,000	1,000,000	248,300	39	750,000
12	1,000,000	1,250,000	345,800	41	1,000,000
13	1,250,000	1,500,000	448,300	43	1,250,000
14	1,500,000	2,000,000	555,800	45	1,500,000
15	2,000,000	2,500,000	780,800	49	2,000,000
16	2,500,000	3,000,000	1,025,800	53	2,500,000
17	3,000,000	3,500,000	1,290,800	57	3,000,000
18	3,500,000	4,000,000	1,575,800	61	3,500,000
19	4,000,000	4,500,000	1,880,800	65	4,000,000
20	4,500,000	5,000,000	2,205,800	69	4,500,000
21	5,000,000	—	2,550,800	70	5,000,000

Current law provides a unified credit against estate and gift taxes in lieu of the prior specific exemptions for estate and gift taxes. Now the estate or the giver will determine the amount of the tentative tax due, and an offset credit will be given to figure the tax payable. The amount of the credit is phased-in over five years according to the following schedule:

Table 2 — Unified Credit for Federal Estate and Gift Taxes.

Year of gift or death	*Unified credit*	*Exemption equivalent*
1977	$30,000	$120,667
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981 and thereafter	47,000	175,625

planning pointers

The unified rates and credits remove some of the tax incentive for making lifetime gifts; however, there still will be tax advantages for making gifts. The gift tax annual exclusion of $3,000 ($6,000 jointly with your spouse) per donee remains unchanged so that such annual gift amounts will continue to escape gift and estate taxes.

There are three reasons why lifetime gifts still save estate taxes, especially for gifts of appreciating property:

1. *the future capital appreciation accrues in the receiver's estate*
2. *earnings from the gift property is income to the receiver, and*
3. *the gift taxes paid are removed from the donor's estate.*

The changes in the federal estate and gift tax law result in fewer estates being taxed; therefore, prior estate planning to minimize taxes by smaller estates may not be needed. All estate plans should be reviewed for implications of the 1976 tax law changes.

marital deduction

A marital deduction is permitted for both estate and gift tax of property transfers from one spouse to another. The amendment increases the estate tax marital deduction for small and moderately sized estates passing to a surviving spouse. An estate is allowed a marital deduction for property passing to a spouse up to the greater of $250,000 or one-half of the decedent's adjusted gross estate, but is limited to the amount the spouse actually receives if the $250,000 or one-half of the adjusted gross estate is greater.

In addition, the amendment provides an increase in the gift tax marital deduction for lifetime gifts to a spouse. A donor is allowed an unlimited marital deduction for the first $100,000 of lifetime gifts made to a spouse, no exemption for the next $100,000 and, thereafter, a deduction for one-half of the aggregate lifetime gifts made to a spouse in excess of $200,000. In general, the gift tax marital deduction is to be integrated with the estate tax marital deduction so that the estate tax marital deduction will be adjusted in certain cases to reflect the marital deduction attributable to lifetime gifts.

planning pointers

If your estate is under $500,000, consider leaving more property to your spouse, because the estate tax marital deduction has been increased. If your will or trust contains a maximum marital deduction formula clause, have it reviewed for a possible new clause to allow for the $250,000 marital deduction. Also consider making lifetime gifts to your spouse in order to take advantage of the unlimited $100,000 gift marital deduction.

estate tax calculation

an example:

This example assumes that a married decedent leaves the adjusted gross estate (gross estate less debts, administration expenses, etc.) to the spouse, and no lifetime gifts have been made prior to the estate being taxed. Table 3 shows an example of the tax calculation for the amended law (1981 unified credit) with a $600,000 gross estate and a $400,000 adjusted gross estate.

In the case of a widow, widower or single person with a $400,000 adjusted gross estate, the federal estate tax, (subtracting the unified credit), is $74,800. The example in Table 3 shows the calculation for the 1981 and thereafter unified credit. If the deceased died prior to 1981, a tax would be due if the credit was less than the tentative federal estate tax.

Table 3 — Federal estate tax on a $600,000 gross estate under amended law (1981 unified credit). Maximum allowable marital deduction taken with spouse receiving all the estate.

Item	*Amended law (1981 unified credit)*
Gross estate	$ 600,000
Debts	— 170,000
Estate administration	— 30,000
Adjusted gross estate	$ 400,000
Marital deduction	— 250,000
Net taxable estate	$ 150,000
Tentative federal estate tax	$ 38,800
Unified credit, 1981*	— 47,000
Federal estate tax†	$ 0

* *See Table 2.*

† *Before state tax credit and prior transfer credit.*

gift and estate tax calculation

an example:

A widow or widower dies, leaving the adjusted gross estate to the children. Lifetime gifts of one-half the property owned have been given to the children at least three years prior to death. Table 4 shows an example of the gift and estate calculation for a $400,000 adjusted gross estate.

Table 4 — Federal estate and gift tax on a $400,000 adjusted gross estate (1981 unified credit). Lifetime gifts of one-half the property given to the children at least three years prior to death.

Item	*Amended law (1981 unified credit)*
Adjusted gross estate	
Prior to gifts	$ 400,000
Lifetime gifts	— 200,000
Adjusted gross estate after gifts	$ 200,000
Gift Tax Calculation	
Taxable gift	$ 200,000
Tentative federal gift tax	54,800
Unified credit, 1981	— 47,000
Federal gift tax	$ 7,800
Estate Tax Calculation	
Taxable estate	$ 200,000
Tentative federal estate tax	67,000
Unified credit, 1981*	—
Federal estate tax†	$ 67,000
Combined federal estate and gift tax paid	$ 74,800

* *No unified credit is available for the estate transfer because the $47,000 was completely used for the lifetime gifts*

† *Before state tax credit and prior transfer credit.*

fractional interest rule for spouse

The gross estate of a decedent includes the entire value of property held jointly by a husband and wife except to the extent that the surviving spouse meets the test of "consideration-furnished;" that is, financial responsibility for acquisition of all or a part of the property through earned employment income, gifts from third parties and inheritances. This test of "consideration-furnished" resulted in substantial problems under prior law. The 1976 amendment resolves these problems by providing a "fractional interest rule" for spouses.

In general, if husband and wife hold property jointly with rights of survivorship (tenancy-by-the-entirety[2]), and a joint tenancy is created by a gift transfer subject to gift tax, then for estate tax purposes the property is treated as belonging 50 percent to each spouse. Subsequent additions in value (such as mortgage payments) will be treated as additional gifts if the taxpayer elects to have the creation of the tenancy-by-the-entirety treated as a transfer for purposes of the gift tax. Subsequent appreciation in value of the property, if any, will not be treated as an additional gift but will be shared equally by the spouses.

In short, if spouses want to own their property equally for tax purposes, it takes a positive act of filing gift tax returns and making gifts to a spouse of part of the property value in order to split the property in the estate. Timely gift tax returns and gifts will also have to be made during years when principal payments are being made. If gifts are not made to a spouse, and gift tax returns are not filed, the pre-1977 interpretation of "consideration-furnished" tests will be taken into consideration in determining in whose estate the property will be included.

planning pointers

Review the jointly held property between husband and wife, and evaluate the potential tax savings by making lifetime gifts from the spouse who paid for the property to the other spouse in order to remove a portion of the property from the estate. If a joint interest is established now, only half the property will normally be taxed in the estate of the first to die. Gift taxes might be payable on the changes, but the estate tax savings later on could be worth it for estates of one-half million dollars or more. Consider using the fractional interest rule for property acquired after 1977 in order to reduce future estate taxes.

joint interest exclusion

Owners of farms and businesses now have another optional procedure whereby services performed by the spouse can be measured and taken into account in determining the federal estate tax. It is called a **joint interest exclusion.** The exclusion is elected at the time a federal estate tax return is prepared and filed and is a reduction in the gross estate before other deductions and credits are taken on the federal estate tax return. It applies to estates of decedent's dying after December 31, 1978.

The joint interest exclusion applies to property in an estate held by the decedent and the decedent's spouse as joint tenants or as tenants by the entirety, but only if the joint interest was created by the decedent, the decedent's spouse or both; and in the case of a joint tenancy, only the decedent and the decedent's spouse are joint tenants. Property means any interest in real or tangible personal property which is devoted to use as a farm or used for farming purposes or is used in any trade or business. The exclusion applies to the estate if the surviving spouse had materially participated in the operation of the business.

Material participation in the operation of the business is determined in a manner similar to the federal income tax law relating to the definition of net farm earnings for the self-employment tax. In general, material participation means engaging to a material degree in the physical work required to produce crops or commodities or in the management decisions necessary to their production.

The joint interest exclusion has two limits which apply to the estate. (1) The exclusion may not reduce the gross value of the eligible joint interest property by more than 50 percent, and (2) the total decrease in the value of the decedent's gross estate resulting from the joint interest exclusion may not exceed $500,000.

The amount of the joint interest exclusion is the sum of:

1. The adjusted consideration furnished by the decedent's spouse, and

[2]*See page 4.*

2. The calculated contribution by the spouse.

The adjusted consideration means the original consideration furnished by the individual concerned when the property was purchased plus the amount of interest the consideration would have earned over the period while invested in a farm or business at a 6 percent simple interest rate. For example: individual "A" purchased a farm 20 years ago for $10,000. The $10,000 is the consideration furnished and the interest earned from the farm is $12,000 ($10,000 X 20 X .06). The adjusted consideration is $22,000 ($10,000 + $12,000).

The calculated contribution by the spouse is determined by this formula:

1. **MULTIPLY:** the value of the joint interest

2. **LESS THE :** Adjusted consideration furnished by the decedent, the decedent's spouse, or both

3. **BY** : 2 percent for each taxable year in which the spouse materially participated in the operation of the farm or business, but not to exceed 50 percent.

For example: individual "A" purchased a farm 20 years ago for $10,000. The farm is now part of "A's" estate with a fair market value of $100,000. Individual "B", "A's" spouse, materially participated in the operation of the farm for 20 years, but did not provide any consideration when the farm was purchased. The calculated contribution by the spouse is as follows:

Value of the joint interest	:	$100,000
Adjusted consideration by "A":		–22,000
Excess	:	$ 78,000
Percentage rate = 2% X 20 yrs.:		X .4
Calculated contribution	:	$ 31,200

The amount of the joint interest exclusion in this example is $31,200 since the spouse furnished no consideration towards the farm's purchase. The value of the farm in "A's" gross estate is $68,800 ($100,000 — $31,200).

planning pointers

The joint interest exclusion makes jointly held property between husband and wife more advantageous now for couples with farm or business property. Since the exclusion is only limited by the lesser of 50 percent of eligible joint interest or $500,000, substantial estate tax savings are possible.

In appropriate situations, it may be advisable to retain farm or business property and dispose of other property during lifetime. A surviving spouse must materially participate in the operation of the farm or business to qualify for the exclusion, so this involvement is important. Because the exclusion for a spouse is based upon the consideration furnished by each spouse, keep detailed records of how property was acquired and how long it is owned.

Only limited planning during lifetime is needed to take advantage of the joint interest exclusion since the election to use the exclusion is made at the point of filing a federal estate tax for a decedent. A word of caution, however, should be given to owners of farms and businesses. The federal estate tax reform has provided special tax-saving features in the form of liberalized marital deductions, alternative use valuation of farms and closely held businesses and a joint interest exclusion for farms and businesses. Theoretically, a married couple could transfer approximately a 1.4 million dollar estate between them without a federal estate tax. But the federal estate tax on the surviving spouse's 1.4 million dollar estate would be approximately $466,000. Estate planning to reduce the surviving spouse's federal estate tax obligation may be critical to minimizing death taxes for the family.

valuation of certain real property

Prior law provided no preferential valuation or special exemptions for farm estates or closely held businesses. Like all estates, farm property and other real estate are valued for estate tax purposes at the fair market value of the property at the date of death or six months later, determined on the basis of highest or best use. The executor chooses the evaluation date.

The 1976 amendment provides that, if certain conditions are met, the executor may elect to value real property which is devoted to farming or other closely held businesses on the basis of such property's value as a farm or closely held business rather than its fair market value. However, this special valuation cannot reduce the decedent's gross estate by more than $500,000.

To qualify for this special valuation:

1. the farm real and personal property must be at least 50 percent of the adjusted gross estate
2. the farm real estate must be at least 25 percent of the adjusted gross estate
3. the qualified property must pass to a qualifying heir; that is, a member of the decedent's family, including the ancestors or lineal descendents, lineal descendents of grandparents, spouse or spouses of any such descendents. An individual's adopted child is treated as a child of his blood, and
4. the decedent or a member of the family must have used the real property as a farm or other closely held business for 5 of the last 8 years prior to the decedent's death and have "materially participated" in the operation of the business for 5 of the last 8 years prior to the decedent's death. Material participation is determined in a manner similar to the federal income tax provision relating to whether the income generated would be subject to self-employment taxes. In general, this means that the income must be from a trade or business, and rental income is excluded even if it is paid in crop shares.

If the farm qualifies for this special valuation, its value is determined by this formula:

1. **DIVIDE** : the average annual gross cash rental for similar land in the locality
2. **LESS THE:** average annual state and local real estate taxes for such comparable land
3. **BY** : the average annual effective interest rate for all new Federal Land Bank loans.

For example: a farm will be valued at $525 per acre if cash rent is $50, property taxes $8 and the Federal Land Bank loan rate 8 percent ($50 — 8 = $42 per acre; $42 ÷ .08 = $525 per acre). For purposes of this rule, the computation is made on the basis of the five most recent calendar years ending before the date of the decedent's death. This evaluation procedure or alternative evaluation methods can be used to value the property. Other evaluation methods are based on the capitalization of the income from the property or the capitalization of fair rental values.

If the special evaluation method is used to value farms, and if within 15 years after the death of the decedent, the property is sold or ceases to be used for farming, any tax benefits obtained by virtue of the reduced valuation are recaptured. Full recapture is provided for the first 10 years with a phase-in of the amount subject to recapture during the remaining 5 years. If the qualified heir dies without having disposed of the property or converting it to a nonqualified use, or a period of 15 years from the decedent's death lapses, the potential liability for recapture ceases.

planning pointers

This rule reduces the estate tax value of qualified real property only under the special circumstances enumerated in the law. Check the requirements for qualification against your estate. Where an individual has a substantial interest in farm real estate or in a business owning real estate, explore the possibility of achieving estate tax savings by a reduction in value.

There is only one limitation on the allowable reduction in value: the value of the decedent's gross estate may not be reduced by more than $500,000. Consequently, in a large estate, there can be substantial estate tax savings.

In an appropriate situation, it may be advisable to retain qualified property and dispose of other property during lifetime. It may also be advantageous to provide in a will for the disposition of qualified property to a qualified heir and to leave other property to other persons.

Many detailed rulings and regulations are yet to be given which will guide the alternative farm evaluation method. Continue to keep abreast of those details so your farm estate qualifies for the alternative evaluation.

orphan's exclusion

The 1976 amendment provides a new estate tax deduction for an amount left to a decedent's child under 21 who has no known parent, and there is no surviving spouse of the decedent. In such cases, a transfer at death to the orphan allows an exclusion in computing the decedent's taxable estate. The orphan's exclusion is equal to $5,000 multiplied by the difference between 21 and the child's age in years at the date of the decedent's death. The orphan's deduction will apply to each minor child of the decedent, including any child by adoption.

planning pointers

Families with minors may find it worthwhile to include in a will a provision for a bequest tied to this deduction. Many alternative means, such as trusts or outright ownership, are available for transferring property to a minor. Determine the best method, considering your family situation.

retirement benefits

The 1976 amendment provides an exclusion from the gross estate for the value of an annuity received by a beneficiary under an individual retirement account (IRA) or Keogh retirement program which the decedent had established as a self-employed retirement plan to the extent that an income tax deduction was allowable when the contribution to such an account, annuity, bond or plan was made. However, the exclusion from the estate tax for these items and all qualified plans will not apply to lump sum distributions.

planning pointers

In the past, self-employed individuals could not avoid the estate tax on their Keogh or IRA retirement plans. The 1976 law excludes such death benefits from the estate tax if the death benefits are not paid out in a lump sum. Therefore, selecting the manner of paying death benefits will now have estate tax significance and should be considered in estate planning. The new exclusion for self-employed retirement plans makes these plans more attractive.

generation skipping

Under pre-1977 law, a property owner could transfer property to children for their lifetime, with the remainder interest transferred to grandchildren and avoid a transfer tax on such property in the estate of the children. Although the value of the property would be included in the estate of the property owner, the children (the skipped generation) had possession and income rights only during their lifetimes. They did not have sufficient ownership interest to cause such property to be included in their estates at death.

Under the 1976 law, a tax is imposed when a trust or similar arrangement (such as a life estate) transfers property and skips a generation. Upon distribution of the trust assets to the generation-skipping heir or termination of an intervening interest, the tax that becomes due is substantially the same as the estate tax that would have been imposed if the property had been transferred outright to each successive generation. The generation-skipping tax will not be imposed in the case of outright transfers.

There is an important exception. If the generation-skipping transfer is to a grandchild — the most probable case — the tax will not be imposed on the termination of the trust or life estate for amounts transferred up to $250,000 of principal per child. Above that amount for children and all other generation-skipping for others, such transfers will incur a tax.

The most commonly used trust or life estate is one to benefit a widow or widower during their lifetime after the death of their spouse. This is not a generation-skipping transfer since the widow or widower is the same generation as the grantor, so no special generation-skipping tax applies in this case.

planning pointers

Because the exemption is quite large for generation-skipping transfers to grandchildren, and trusts or life estates to benefit a spouse are not taxed, trusts and life estates remain an excellent tax-savings tool for estates. Investigate how your estate and heirs can benefit through these tools. For larger estates and generation-skipping transfers to heirs other than the immediate family, the new tax is a factor to consider in estate planning.

extended payment time

A 15-year period is allowed for paying an estate tax, if the value of a farm or closely held business is at least 65 percent of the value of the decedent's adjusted gross estate. Where an estate qualifies for this 15-year extension of payment, 4 percent interest is charged on the unpaid tax balance for the first $1 million of property and a higher rate on the excess.

planning pointers

The new extension of time to pay the estate tax and reduced interest rate for payment on a farm or closely held business constitute a valuable benefit for a qualified estate. Therefore, where an individual's assets consist substantially of a farm or closely held business, check to determine whether the estate qualifies.

filing requirements

Federal estate tax

An estate tax return must be filed for an estate whose gross value exceeds the amount of the exemption equivalent (Table 2) on the date of death. Upward adjustments are made with respect to how large a gross estate must be before a return must be filed to conform to the phase-in of the higher unified credit or exemption equivalent. For those dying in 1977, an executor must file a return if the gross estate exceeds $120,000, $134,000 in 1978, $147,000 in 1979, $161,000 in 1980 and $175,000 in 1981 or thereafter.

The estate tax return must be filed within 9 months after the date of death and the tax paid at the time of filing. Penalties will be assessed against the estate for late filing and failure to pay the tax. Federal estate tax return, Form 706, is used to file for estates.

Federal gift tax

A donor is required to file a gift tax return reporting gifts of present interest of $3,000 or more to any one donee in any one year and gifts of future interest of any amount.

If a gift tax return is required, it must be filed in a quarter in which cumulative taxable gifts made during the calendar year exceed $25,000. Quarterly returns are due 15 days after the second month following the close of the quarter. If gifts do not exceed $25,000 in a calendar year, only one gift tax return need be filed on February 15 following the end of the calendar year. Gift tax return, Form 709, is used to file gifts.

carryover basis

Prior to 1977, the federal income tax law allowed the basis of inherited property to be stepped up or down to its value on the date of the decedent's death. The Tax Reform Act of 1976 changed this rule and required the basis of property passing from a decedent to be "carried over" from the decedent to the estate or beneficiaries for purposes of determining gain or loss for sales and exchanges by the estate or beneficiaries. Estate administrative problems have been experienced in implementing the carryover basis rule; therefore, the effective date for starting the carryover basis provisions for property acquired from decedents has been postponed.

At the time of this revision, no decision has been made by Congress on the carryover cost basis rules. Check the current rules with your tax advisor if it affects your estate planning. Property acquired from a decedent during the interim receives a stepped up basis at its fair market value at the date of the decedent's death or the alternative valuation date.

summary

The above discussion was limited to some of the major provisions under the law. Each of the new provisions, and the law itself, is enough detailed and complicated to require competent counsel in planning estates. Individuals who have established estate plans, under the prior law, are encouraged to review the present plans and to determine whether the amended law should result in some changes. Those who have done little planning are encouraged to start now.