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Michigan Inheritance Tax

Michigan State University Extension Service

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# Michigan Inheritance Tax

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An objective in estate planning for most families is minimizing the amount of death taxes to be paid. At death, Michigan imposes a transfer tax upon the market value of the heirs' share of an inheritance.<sup>1</sup> All real and personal property owned by a Michigan resident decedent and all real property located in Michigan but owned by a non-resident decedent is subject to the tax. Because of various personal exemptions and property exclusions, the tax may or may not be important for your estate. You must understand the law's provisions in order to make this determination. Major provisions of the law are explained in this bulletin including estate planning pointers to help Michigan families manage the tax.

## Transfers Subject to the Tax

Property transfers are subject to the tax when made by:

1. Will or intestate laws of Michigan (Michigan laws which govern the distribution of estates of person's dying without leaving a valid will). Examples of property ownership which pass through the terms of the will or intestate laws are property owned solely by the deceased and the decedent's share of tenancy-in-common property. 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 share in the property is included in the taxable 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 estate,

2. Grant or gift made within two years of death which are made in contemplation of death, and
3. Grant or gift made during lifetime which takes effect at or after death. Retained life estates, trusts 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 taxable estate. A similar result occurs if the decedent had the right to designate the person who shall possess the property or receive the income from the property. Transfers intended to take effect at death are also included in the taxable estate.

Property transfers which are not subject to the tax are as follows:

1. Jointly held property whether joint tenancy with rights of survivorship or tenancy by the entirety. 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 ownership rights. Tenancy by the entirety is a special type of joint tenancy with rights of survivorship between husband and wife. Upon the death of one joint owner, the survivors do not take ownership by descent, distribution or transfer but by right of survivorship and there is no transfer and no inheritance tax. The fact that one owner contributed all the property or had the right to revoke the joint ownership does not make the property taxable,
2. Life insurance proceeds paid to the estate are subject to the tax, but proceeds paid to named beneficiaries are not subject to the tax.
3. All property transfers to a spouse which otherwise would be subject to the tax are exempt. The marital deduction for property passing to the decedent's spouse is effective for all estates after December 31, 1982.

<sup>1</sup>Property transfers at death are also subject to the Federal Estate tax. Information on the federal tax may be found in Ext. Bul. E-1231, "Federal Estate and Gift Taxes." Cooperative Ext. Serv., Michigan State University.

## Deductions

Items which reduce the value of the inheritance are allowed as deductions before the tax is determined. Common deductions are as follows:

- funeral expenses
- estate administration expenses (legal fees, executor's fees, probate court costs)
- debts and claims owing at the time of death
- mortgages and liens

## Class of Heirs

Exemptions and tax rates are unique to a predetermined class of heirs who receive property from the decedent. Persons taxed by the Michigan inheritance tax fall into two classes:

Class I—grandfather, grandmother, father, mother, husband, wife, child, brother, sister, wife or widow of a son, the husband of a daughter, adopted child, a person to whom the decedent stood in the mutually acknowledged relation of a parent if the relationship began at or before the child's seventeenth birthday and continued until the death of the decedent and a lineal descendent of the decedent.

Class II—All other heirs not included in Class I.

## Exemptions

Personal exemptions for each class of heirs are as follows:

Class I—\$10,000

Class II—None. There is no tax on the share of any beneficiary if the value of the share is less than \$100.

Charitable exemptions—Property transfers to charitable, religious, educational or public institutions are exempt if the recipient is exempt from property taxation and one of the following:

1. A Michigan corporation specifically organized for the above purposes.
2. A Michigan unincorporated foundation for the above purposes, but only if it was in existence prior to May 15, 1949.
3. A foreign corporation for the above purposes if the state in which that corporation was organized grants similar exemption from inheritance taxes to a resident of the state who leaves money to a similar Michigan corporation.

Farm real property exemption—There is exempt from tax 50 percent of the market value of transferred qualified farm real property. (Discussed in more detail under farm real property provisions.)

## Tax Rates

As Table 1 illustrates, the graduated rates vary depending upon both the value of the inheritance and the relationship of the beneficiary to the decedent. The

Table 1. Michigan inheritance tax rates for class of heirs

Value of inheritance	Class I	Class II
	heirs	heirs
	---- Percent ----	
0 to \$50,000	2	12
\$50,000 to \$250,000	4	14
\$250,000 to \$500,000	7	14
\$500,000 to \$750,000	8	17
\$750,000 and over	10	17

value of the inheritance is the market value of the property reduced by unpaid mortgages, debts or liens on the property.

The inheritance tax is determined by: (1) separating the heir's share into the appropriate tax brackets, (2) assessing the rate for each range, and (3) summing up the parts to yield the total inheritance tax due for the heir. The heir's personal exemption is deducted from the lowest tax brackets rather than from the entire value of the transfer.

## Inheritance Tax Example

This example assumes that a married decedent leaves jointly held property, life insurance and solely owned property to his spouse. This property is not subject to the inheritance tax. Other property, solely owned by the deceased is part of the taxable estate and has a net value of \$140,000. The property is transferred to the following heirs and taxed according to the calculation in Table 2.

The \$10,000 exemption for each child is taken from the lowest tax bracket and the two and four percent rate applied to the remaining taxable inheritance. The exempt charity has a complete exemption for the property transferred. The neighbor has no personal exemption and the inheritance is taxed at the 12 percent rate.

## Additional Tax

An additional Michigan inheritance tax may be due on an estate which must pay a Federal estate tax. The Federal estate tax has a tax credit for state taxes based upon a schedule according to estate size. If the Federal estate tax credit for state taxes is larger than the inheritance tax paid to Michigan, the difference is paid as a Michigan inheritance tax.

The county treasurer collects an additional tax of one-half of one percent on the Michigan inheritance tax paid and credits the fee to the general county fund.

Table 2. Inheritance tax on a \$140,000 taxable estate

Heir	Value of taxable inheritance	Exemption	Inheritance taxed	Tax rate %	Inheritance tax
Son	60,000	10,000	Exempt	2	—
			40,000	2	800
			10,000	4	400
Daughter	60,000	10,000	Exempt	2	—
			40,000	2	800
			10,000	4	400
Exempt charity Neighbor	10,000	10,000	Exempt		—
	10,000	—	10,000	12	1,200
Total	\$140,000	\$30,000	\$110,000		\$3,600

### Planning Pointers

The Michigan inheritance tax has low tax rates for property subject to the tax for close family members. In most cases, married couples (first marriage) own their property jointly, have retirement benefits and life insurance which transfers directly to the named beneficiary or transfer property to the surviving spouse. Property owned and transferred by these methods is not subject to the inheritance tax.

Couples with a medium (\$250,000 to \$500,000) or large estate (\$500,000 or more) should obtain tax counsel in planning both estates since the inheritance tax and Federal estate tax on the surviving spouse's estate may be large if all property is transferred to the surviving spouse. In large estates, transfers to the surviving spouse may minimize the inheritance tax on the first transfer, but may be expensive for the second transfer.

Second marriages, especially where there are children from a previous marriage, have separate issues to be considered other than tax planning. Obtain legal counseling in planning the estate so property is transferred to heirs whom you want to receive the property. Then consider tax issues.

Widows, widowers and single individuals have other issues that need to be considered when transferring their estate. While owning the property jointly with their heirs has inheritance tax implications, the process of adding an heir's name to property may have Federal gift tax impacts and property control and ownership implications. Jointly held property between single individuals and their heirs should be used only in special situations. Obtain legal counsel before changing the way property is owned so you understand the consequences during your lifetime and how the property is taxed.

### Filing Requirements

If property is subject to the Michigan inheritance tax, an inheritance tax order must be obtained from the Probate Court. The Probate Court having jurisdiction of the decedent's estate has authority to hear and determine the inheritance tax.

The inheritance tax must be paid within nine months after the date of death. Penalties and interest will be assessed against the estate for late filing and failure to pay the tax. The person to whom the property is transferred and the personal representative of every estate are liable for the tax until its payment. The personal representative, however, is not liable for the tax on the remainder, consisting of farm real estate, when an election is made to defer the payment of the tax on the farm.

### Farm Real Property Provisions

The transfer of farm real property is eligible for two optional tax saving provisions under the amended Michigan inheritance tax law if the estate meets the qualifying conditions. The two provisions are:

1. A 50 percent farm exemption for the market value of farm real property, and
2. A deferment of the inheritance taxes on the remaining half of the farm real property.

The farm exemption and deferred inheritance taxes are recaptured if the heir sells the farm or ceases to use the property for farming within a ten year period. If the law's provisions are met for a ten year period, the farm exemption becomes permanent and the deferred inheritance taxes become a lien against the property and are due at that time.

### Qualifying Conditions

In order for the estate to qualify for the farm exemption and deferred inheritance taxes on the farm real prop-

perty all of the following conditions must be met:

1. The estate fiduciary and the farm heir must apply for the optional tax saving provisions with the county probate judge.
2. The farm real property must be transferred to a "qualified heir." A "qualified heir" is any individual listed above under a Class I heir. In addition, a widower of a daughter and a farm business partner are qualified heirs.
3. The farm heir must apply for a "Farmland Development Rights Agreement—P.A. 116" on the farm real property and receive an acceptance of the Agreement (Agreement refers to the Farmland Development Rights Agreement—P.A. 116) from the State Land Use Agency, Department of Natural Resources,<sup>2</sup> and
4. The farm real property must meet the definition of "qualified farm real property." "Qualified farm real property" means real property located in Michigan which on the date of the decedent's death was being devoted to an agricultural use and which meets all of the following conditions:
  - a. The real property is eligible farmland as defined in P.A. 116,
  - b. The adjusted value (adjusted value means the market value less unpaid mortgages, debts or liens on the property) of real and personal property in agricultural use transferred to the "qualified heir" is 50 percent or more of the estate's adjusted value,
  - c. The adjusted value of the farm real property transferred to the "qualified heir" is 25 percent or more of the estate's adjusted value,
  - d. The decedent or a "qualified heir" "materially participated" in the operation of the farm for a period of five years or more in an eight year period ending on the date of the decedent's death. "Material participation" in the operation of the business shall be 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.
  - e. The farm real property is designated in the "Farmland Development Rights Agreement."

The qualifying conditions for the Michigan inheritance tax farm real property provisions are similar to the qualifying conditions under the federal estate tax to

<sup>2</sup>An explanation of the Farmland and Open Space Act—P.A. 116 may be found in Extension Bulletin, E-792A, MSU, Coop. Ext. Serv., Nov. 1978.

value farm real property based on use value rather than fair market value.

### Recapture of Inheritance Tax Savings

The "qualified heir" is subject to recapture of the inheritance tax savings from the 50 percent farm exemption and the deferred inheritance taxes on the remaining value of the farm if two events occur for the "qualified farm real property" which is subject to a Farmland Development Rights Agreement:

1. The heir ceases to use the farm for an agricultural use during the 10 year duration of the Agreement. The total amount of the exempted and deferred inheritance taxes are due with interest at nine percent per year compounded monthly from the time the exemption was received until the taxes are paid, and
2. The heir sells the farm during the 10 year duration of the Agreement. If the farm is sold during the first five years after the effective date of the Agreement, four different obligations apply depending upon who purchases the farm and whether the farm stays in the Agreement.
  - a. If the new owner is another "qualified heir" of the decedent and the owner keeps the farm in P.A. 116, the exempted and deferred inheritance tax liability is transferred to the new owner and the seller pays nothing.
  - b. If the new owner is not another "qualified heir," but keeps the farm in P.A. 116, the seller pays all the exempted and deferred inheritance taxes without interest.
  - c. If the new owner does not keep the farm in P.A. 116 because the seller obtains a release from P.A. 116, the seller pays all the exempted and deferred inheritance taxes with interest at nine percent per year compounded monthly from the time the exemption was received until the taxes are paid.
  - d. If the new owner does not keep the farm in P.A. 116 because the seller was released from P.A. 116 due to death, disability, or public interest, the seller (or estate) pays all the exempted and deferred inheritance taxes without interest.

If the heir sells the farm between six and ten years after the effective date of the Agreement, the same four situations apply, but only a prorated (50 percent or less) of the remaining months of the inheritance taxes and interest are due.

### Case Example

A widow owned a farm valued at \$300,000 and other property valued at \$75,000 and transferred the estate to a surviving child who has been operating the farm. The

**Table 3. Michigan inheritance tax on a \$375,000 gross estate under the amended law**

Item	Alternative Michigan Inheritance Tax Options		
	1 Amended Law without farm real property provisions	2 Amended Law with the farm exemption	3 Amended Law with the farm exemption and the deferred inheritance tax
Gross estate	\$375,000	\$375,000	\$375,000
Debts and estate administration	-15,000	-15,000	-15,000
Adjusted gross estate	\$360,000	\$360,000	\$360,000
Farm exemption	—	-150,000	-150,000
Value of taxable inheritance	\$360,000	\$210,000	\$210,000
Personal exemption	-10,000	-10,000	-10,000
Inheritance taxed	\$350,000	\$200,000	\$200,000
Inheritance tax deferred	—	—	6,000
Inheritance tax due immediately	\$ 16,500	\$ 7,200	\$ 1,200

following calculations and Table 3 show the Michigan inheritance taxes under different options. The example assumes the estate qualifies for the optional farm real property provisions and the heir operates the farm for at least ten years after the effective date of the Farmland Development Rights Agreement.

If the estate does not qualify for or chooses not to apply for the farm real property provisions, the heir pays \$16,500 immediately under option 1. Because of the estate size, the top inheritance tax rate is seven percent. Under option 2, the estate took the farm exemption and paid the \$7,200 remaining inheritance taxes. If the heir continued farming the real property for 10 years, during the period of the Agreement, no other inheritance tax is due on the farm. Part or all of the difference between the \$16,500 and the \$7,200 inheritance tax (option 1 and 2) would be due if there is a recapture of the inheritance tax savings due to not farming the land for 10 years.

Under option 3, the estate paid \$1,200 inheritance tax immediately and deferred the inheritance tax on \$6,000. If the heir continued farming the real property for 10 years, during the period of the Agreement, the inheritance tax on the farm exemption is dropped. The \$6,000 inheritance tax on the deferred part of the farm is a lien against the property after the ten year period and due and payable immediately without interest or penalty. Part or all of the difference between the \$16,500 and \$1,200 inheritance tax (option 1 and 3) would be due if there is recapture of the inheritance tax savings due to not farming the land for 10 years. The determination of inheritance tax for the above example

is based upon the present interpretation of how the taxes are calculated under the optional farm real property provisions. Court cases may result in a different interpretation.

### Planning Pointers

The farm exemption and deferment of inheritance taxes are optional provisions if a farm is subject to the inheritance tax. In many family situations, a lifetime transfer of the farm has been made to the farm operating heir prior to the previous owner's death and the farm is not subject to inheritance taxes. But in cases where the farm has not been transferred and the operating heir intends to own the land for at least 10 years, the farm exemption and deferment of inheritance tax on the farm real property can be an excellent tax minimization strategy. Enrollment in the Farmland and Open Space Preservation Act has property tax implications and may provide further incentive for using the optional farm real property provisions.

### Summary

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

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