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Federal Estate Taxation

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Overview

The federal estate tax is an excise tax levied on the privilege of transferring property at death, with tax liability being measured by the size of the decedent's estate. There are three overriding issues relevant to understanding the federal estate tax. One is the question of when property is valued for federal estate tax purposes. Another concerns how property is valued for federal estate tax purposes. The third issue involves a determination of what property is included in the decedent's gross estate.

Legislation enacted in 2001 made significant changes in the area of federal estate taxation, but most of the significant changes are put off until well into the future. In any event, it is widely believed that most of the changes will never apply, because the Congress is likely to modify the 2001 legislation significantly.

When is Property Valued?

Date of death and alternate valuation date. In general, property is valued for federal estate tax purposes as of the date of death. However, the executor can make an election if the value of the property in the gross estate and the estate's federal estate tax liability are both reduced by making the election and the gross estate exceeds the applicable exemption equivalent of the unified credit for the year of death ($1,500,000 for 2004 - 2005). This is termed an alternate valuation election. If the election is made, the assets included in the decedent's estate are valued at their fair market value as of six months after the decedent's death.

How is Property Valued?

In general. Most assets are valued at fair market value. That's the price at which a willing buyer and a willing seller would exchange the property. For stored grain, for example, fair market value is what the elevator would pay. For feed on hand at death, selling price is an appropriate measure of fair market value.

Special use valuation. The only major exception to the willing buyer/willing seller test, is special use valuation of land used in a farming or ranching (or other closely-held) business. The executor of an estate may elect to value real property devoted to farming or ranching (or other closely held businesses) at its special use or "use" value rather than its fair market value. The most common approach for determining the special use value of agricultural land in a decedent's estate is derived by obtaining cash rent figures on comparable land and discounting that amount by an IRS-prescribed interest rate for the part of the country in which the land is located.

Several requirements must be satisfied before death for a decedent's estate to qualify to utilize special use valuation. The pre-death eligibility requirements are very complex and technical, and a thorough discussion of the provisions is beyond the scope of this publication. However, the most important pre-death requirements are set forth below:

- The farmland and farm personal property must make up at least 50 percent of the adjusted value of the gross estate, using fair market value figures.
- The farmland must make up at least 25 percent of the gross estate less secured indebtedness.
- The decedent or member of the decedent's family must have had an equity interest in the farm operation at the time of death and for five or more of the last eight years before death.
- The decedent-to-be or a member of the decedent-to-be's family must have been actively involved in the farm or ranch business during five or more of the last eight years before the earlier of the decedent's retirement, disability, or death.
- The real estate must have been owned by the decedent or a member of the family and held for a qualified use during five or more years in the eight-year period ending with the decedent's death.
- The qualified real estate must pass to the qualified heir(s) instead of being sold at death.
- The qualified heir(s) must receive a present interest in the property.
- For land owned by a partnership, 20 percent or more of the partnership's total capital interest must be in the decedent's estate or the partnership must have had 15 or fewer partners. For land owned by a corporation, 20 percent or more of the corporation's voting stock must be in the estate or the corporation must have had 15 or fewer shareholders. Estates in which a special use valuation election is made are subjected to a ten-year period during which they will

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have to pay back all the tax benefits if any eligibility rule is violated. This is what recapture means. The following are some of the possibilities and consequences of post-death recapture.

- Recapture occurs if a qualified heir disposes of the land to persons other than members of the family of the qualified heirs during the recapture period.
- Recapture occurs if there is absence of material participation for more than three years in any eight-year period that ends after death.
- Recapture is triggered if there is a change in use of the elected property.
- The qualified use test must be satisfied for the entire length of the recapture period, except for a two-year grace period immediately following death. Each qualified heir must have an "equity interest" in the operation.

If recapture tax is triggered, the amount recaptured is the difference between what the estate would have paid without the election and what it paid with the election.

An IRS lien is imposed on all qualified farm or closely-held business real property for which a special use value election has been made. The lien arises at the time the election is filed and continues until the potential liability for recapture ceases, the qualified heir dies or the tax benefit is recaptured.

What is Included in the Gross Estate?

In general. The gross estate includes all property interests owned in the decedent's name at date of death, including the decedent's portion of tenancy-in-common property or community property and the applicable part of joint tenancy or tenancy-by-the-entirety property.

Retained interests. If an individual makes a gift of property, but keeps some powers over the property, those retained powers will pull the property back into the donor's estate. The retained power to revoke, alter, amend or terminate the transfer causes inclusion of the property subject to the power in the transferor's estate. If the purpose of giving away property is to diminish the size of the estate so as to save federal estate tax, no powers over the property should be retained.

Powers of appointment. The gross estate includes property over which the decedent possessed a general power of appointment. With a general power of appointment, the holder gets the power to designate who gets the property subject to the power, including the holder. The power is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or creditors of the decedent's estate. A general power is fully taxable because it pulls of the property subject to the power into the power holder's estate.

Gifts within three years of death. Gifts made within three years of death are included in the gross estate only in specified instances. These instances include situations where (1) the decedent retained a life estate in the property; (2) the transfer is to take effect at death; (3) the transfer is revocable; or (4) the transfer involves life insurance policies.

Deductions From the Gross Estate

Administrative expenses. Attorney's fees, executor's fees, court costs, costs associated with the last illness, death and burial costs, debts of the decedent and losses from fire, storm, or other casualty or theft loss occurring during estate settlement are all deductible if they are deductible under local law and are reasonable and necessary administrative expenses.

Marital deduction. The marital deduction applies to property passing to the surviving spouse. If there is no surviving spouse, there is no marital deduction. The marital deduction is 100 percent for qualified property. Thus, it is possible to entirely eliminate the federal estate tax liability upon the first spouse's death by simply leaving everything to the surviving spouse outright in a form qualifying for the marital deduction.

The family-owned business deduction (FOBD). The FOBD is modeled closely after special use valuation with many of the major tests and requirements drawn from special use valuation. However, while special use valuation applies only to land, the FOBD applies to all assets used in the farm, ranch or other closely-held business. The assets involved are valued at fair market value in the traditional manner, except for land that is subject to a special use value election. In that case, the use value is the value used for FOBD purposes.

The value of qualified family-owned business interests (QFOBIs) is included in the gross estate with the maximum deduction for qualified interests set at $675,000. If an estate includes less than $675,000 of QFOBIs, the unified credit exemption amount is increased on a dollar-for-dollar basis to the extent of the shortfall, but only up to the applicable exclusion amount otherwise available for the year of death.

A number of pre-death eligibility requirements apply.

- The decedent must have been a citizen or resident of the United States at the time of death, and the principal place of business must be in the United States.
- The aggregate value of the decedent's QFOBIs must exceed 50 percent of the adjusted gross estate.
- The decedent's QFOBIs must pass to or be acquired by qualified heirs.
- A trade or business must exist, and certain passive assets do not qualify.
- The decedent or a member of the decedent's family must have owned and materially participated in the trade or business for at least 5 of the 8 years immediately preceding the earlier of the decedent's death, disability or retirement.
- It is likely that a qualified heir must receive a present interest in the property. The FOBD rules levy a recapture tax if, within 10 years of the decedent's death and before the qualified heir's death, a recapture event occurs. Recapture is triggered by any one of the following events:
- Disposal of a portion of a QFOBI other than to a member of the qualified heir's family or through a qualified conservation contribution.

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- Absence of material participation by the qualified heir or a member of the qualified heir's family for more than 3 years in any 8-year period ending after death.
- Sale or exchange of grain or livestock in inventory, sale or exchange of machinery and equipment or transfer of other property to persons other than members of the qualified heir's family. An IRS lien is imposed on all qualified farm or closely held business real property for which an election has been made to exclude the property from the decedent's estate. The lien arises at the time the election is filed and continues until the possibility for recapture ceases, the qualified heir dies, or the tax benefit is recaptured.

Legislation enacted in 2001 repeals FOBD for deaths after 2003. However, the FOBD recapture provisions continue to apply after FOBD is repealed.

Charitable deduction. An unlimited charitable deduction exists for property included in the decedent's gross estate that passes to a qualified charity.

The Taxable Estate

A decedent's taxable estate is determined by subtracting from the decedent's gross estate (adjusted for gifts and gift tax within 3 years of death except for amounts covered by the federal gift tax annual exclusion), costs of estate administration, allowable losses, the marital deduction, the FOBD (if elected), and charitable deduction. Taxable gifts after 1976 (those not covered by the federal gift tax annual exclusion, marital deduction or charitable deduction) are included in the taxable estate for purposes determining the amount of prior use of the unified credit and the point to begin figuring federal estate tax on the graduated tax schedule. In essence, a credit of $555,800 (for 2004 and 2005) is available to offset gift tax during life or to be applied against estate tax at death.

The Unified Credit

Once all items are included in the calculation of the gross estate and all appropriate deductions are taken, the federal estate tax is computed. After the federal estate tax is computed, certain credits may be subtracted. The most valuable credit is the unified credit. For deaths in 2004 and 2005, the tax is calculated and $555,800 is subtracted. Once an estate has a tax liability greater than the unified credit, the federal estate tax applies. Everything is covered up to $555,800 (for deaths in 2004 and 2005) which shelters the equivalent of $1,500,000 worth of property. A taxable estate of $1,500,000 owes no federal estate tax because it will all be covered by the unified credit.

Planning to Minimize Federal Estate Taxes

In general. Different strategies may be utilized to transfer property to subsequent generations at the least tax cost. Of course, the best strategy depends upon the objectives to be accomplished.

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