MSU Ag Facts — Extension Bulletin E-1231, November 1981, FILE 17.151

Federal Estate and Gift Taxes

by Ralph E. Hepp
Department of Agricultural Economics

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 and the Economic Recovery Tax Act of 1981 made substantial changes in the federal estate and gift tax law. The reforms have drastically liberalized the exemptions and deductions and have 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 personal representative 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 special use valuation of certain real property, which is discussed in a later section.

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 person whose interest is subject to special rights for the spouse). 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 ownership 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

[1] *Transfers at death are also subject to the Michigan Inheritance tax, but the Michigan tax is discussed in bulletin E-1348, Michigan Inheritance Tax.*

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. The estate of the first deceased spouse will include one-half of the value of the property regardless of which spouse furnished the consideration for the property.

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. 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.

7. 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 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.

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 amount of property transferred to the decedent's spouse, and
2. the value of property transferred to or for the use of charitable, educational, religious or public institutions or to the government.

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 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 $10,000 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 lifetime gifts made to a spouse.

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

The value of the taxable estate or gift is taken to the rate schedule and a tentative tax calculated (Table 1). The rates are progressive, starting at 18 percent and increasing to 50 percent for cumulative taxable transfers in excess of $2.5 million (For decedent's dying prior to 1985 with taxable estates above $2.5 million, the tax rate varies between 53 and 70 percent at the upper levels). A single, unified rate schedule is used for lifetime gifts and death transfers. If lifetime gifts above the $10,000 annual exclusion are made and a tentative gift tax is calculated, the taxable estate starts in the table at the bracket level and tax rate where taxable gifts stopped.

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.

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. In 1981 the law provides a $47,000 unified credit against estate and gift taxes. The amount of the credit is phased in at higher levels over six years according to the following schedule.

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	—	1,025,800	50	2,500,000

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

Year of gift or death	Unified credit	Exemption equivalent
1982	$ 62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and thereafter	192,800	600,000

Planning pointers

A $600,000 exemption equivalent (phased in), an unlimited marital deduction and a $10,000 gift tax annual exclusion eliminates the federal estate and gift tax concerns for families with small and medium sized estates. For these families, estate planning can focus on the needs of individuals and tax planning de-emphasized.

Families with larger estates where estate tax planning remains an important objective can use a combination of gifts and other tools to manage the tax burden. The liberalized gift tax annual exclusion of $10,000 ($20,000 jointly with your spouse) per donee remains an attractive alternative for transferring property within the family and escaping the gift and estate taxes. There are four reasons why lifetime gifts save estate taxes, especially for gifts of appreciating property:

1. The amount of the gift is removed from the giver's estate,

2. the future capital appreciation accrues in the receiver's estate,

3. earnings from the gift property is income to the receiver, and

4. the gift taxes paid (if any) are removed from the donor's estate.

The unlimited marital deduction greatly changes the gift and estate planning strategies for married persons within reach of estate and gift tax liability. For such families there is a greater need now for trusts or other tools to minimize the estate tax on the surviving spouse'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 and medium estates may not be needed. All estate plans should be reviewed for implications of the tax law changes.

Estate tax calculation

an example:

The example assumes that a widow, widower or single person leaves the adjusted gross estate (gross estate less debts, administration expenses, etc.) to the heirs, 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 (1987 unified credit) with a $800,000 gross estate and a $600,000 adjusted gross estate. If the deceased died prior to 1987, a tax would be due if the credit was less than the tentative federal estate tax.

Table 3 — Federal estate tax on a $800,000 gross estate under amended law (1987 unified credit)

Item	Amended law (1987 unified credit)
Gross estate	$800,000
Debts	-170,000
Estate administration	- 30,000
Adjusted gross estate and taxable estate	$600,000
Tentative federal estate tax	$192,800
Unified credit, 1987*	$192,800
Federal estate tax**	$ 0

*See Table 2

**Before state tax credit and prior transfer credit.

Valuation of certain real property

Farm 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. If this method of valuing real property becomes a financial burden on the estate, the personal representative may elect to value real property which is devoted to farming or other closely held business on the basis of such property's value as a farm or closely held business rather than its fair market value. However, special use valuation cannot reduce the decedent's gross estate by more than $600,000 if the death occurred in 1981, $700,000 if the death occurred in 1982 and $750,000 if the death occurred in 1983 and thereafter.

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 an individual's spouse, parents, brothers, sisters, children, stepchildren, spouses, and lineal descendants of those individuals. A qualified heir may purchase property from a decedent's estate and keep the property eligible for special use valuation, 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 preceding the earliest of: 1) the date of the decedent's death; 2) the date the decedent became disabled; or 3) the date the decedent retired. 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 share.

   Material participation requirements for eligible qualified heirs who receive property need only meet an active management test. Eligible qualified heirs include the decedent's spouse or a qualified heir who has not attained the age of 21, who is a full-time student, or who is disabled. Active management means the making of business decisions other than daily operating decisions of the farm or closely held business and, thus, requires less activity than actual material participation.

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

1. DIVIDE : the average annual gross cash rental for similar land in the locality. Net share rentals may be used in the formula if cash rentals for comparable land in the same locality are not available. Net share rental is equal to the value of crops received by the lessor during the calendar year minus the cash operating expenses (other than real property taxes) paid by the lessor for growing the crops.

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 $700 per acre if cash rent is $80, property taxes $17 and the Federal Land Bank loan rate 9 percent ($80 - 17 = $63 per acre; $63 ÷ .09 = $700). 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 10 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. If the qualified heir dies without having disposed of the property or converting it to a nonqualified use, or a period of 10 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 $750,000. 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.

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 current 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 14-year period is allowed for paying an estate tax, if the value of a farm or closely held business is at least 35 percent of the value of the decedent's adjusted gross estate. Where an estate qualifies for this 14 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.

The estate makes an annual interest payment on the tax for the first four years and thereafter pays the tax and interest in up to ten annual installments.

Planning pointers

The 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.

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 $10,000 or more to any one donee in any one year and gifts of future interest of any amount. Interspousal transfers are exempt from filing a gift tax return in accordance with the unlimited gift tax marital deduction.

If a gift tax return is required, it must be filed on April 15 following the end of the calendar year. Gift tax return, Form 709, is used to file gifts.

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 detailed and complicated enough 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.

MICHIGAN STATE UNIVERSITY

MSU is an Affirmative Action/Equal Opportunity Institution. Cooperative Extension Service programs are open to all without regard to race, color, national origin, or sex.

Issued in furtherance of cooperative extension work in agriculture and home economics, acts of May 8, and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Gordon E. Guyer, Director, Cooperative Extension Service, Michigan State University, E. Lansing, MI 48824.

This information is for educational purposes only. Reference to commercial products or trade names does not imply endorsement by the Cooperative Extension Service or bias against those not mentioned. This bulletin becomes public property upon publication and may be reprinted verbatim as a separate or within another publication with credit to MSU. Reprinting cannot be used to endorse or advertise a commercial product or company. O-13266

2R-2P-4M-11:81-UP. Price 30 cents.