

Estate Tax Planning After '81*

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Estate planning since the 1960's has been greatly influenced by the federal estate tax impact on the transfer of farm property through the estate. Farm and small business owners and their professional estate planners have relied upon various techniques and tools to minimize or eliminate the potential estate tax on the estate transfer. Although estate owners have many objectives in estate plan development, the desire to minimize tax has become a dominate objective overriding other concerns.

The Tax Reform Act of 1976 made substantial changes in the federal estate tax which lessened the tax burden on small and moderate-sized estates and increased the tax obligation on larger estates through restricted application of common tax planning tools. The Economic Recovery Act of 1981 continued the basic estate and gift tax reform started in 1977, but greatly liberalized the exemptions, deductions, and qualifying requirements for using special provisions under the law. After 1987, when the \$600,000 unified credit exemption equivalent is phased in, the federal estate tax for small farm estates will be eliminated.

Medium-sized farm estates from \$600,000 to \$1.2 million can eliminate the tax by using commonly accepted estate transfer methods tax planning tools, while large estates, over \$1.2 million, can greatly reduce the federal estate tax burden by implementing tax reduction techniques. For most farm estates, tax planning will be de-emphasized and the needs of the individual family members will again receive the focus of the attention in estate plans.

The purpose of the paper is an analysis of the revised federal estate and gift tax laws and its impact on the commonly accepted estate transfer plans. Seven estate transfer models are evaluated for estate transfer costs for estates ranging in size from \$200,000 to \$2 million of net estate value for a married couple. Estate transfer costs considered are the federal estate and federal gift tax, probate administration costs, Michigan inheritance tax and trust fees. The estate transfer of costs are calculated for the transfer of property between the spouses and the transfer of the couple's property to the heirs. The study assumes four heirs (who are the couple's children) inherit the couple's property, family living cash flows are generated from the property without depleting the estate value and the surviving spouse maintains the original estate value. It also assumes a 5 percent probate administration fee, a seven year period between the transfer of the first and second estate and a trust fee of .7 percent per year.

Estate transfer costs are one of many estate planning objectives when couples plan their estate. The analysis, however, only considers the transfer cost. The outcomes and implications from the analysis needs to be interpreted in light of the study's objective. Before an estate planning model is adopted, the other estate planning objectives need to be considered.

Estate Planning Models

Model I - Tenancy by the Entirety

Model I illustrates tenancy by the entirety property ownership and transfer for a married couple (Figure 1). During their lifetime they own the property

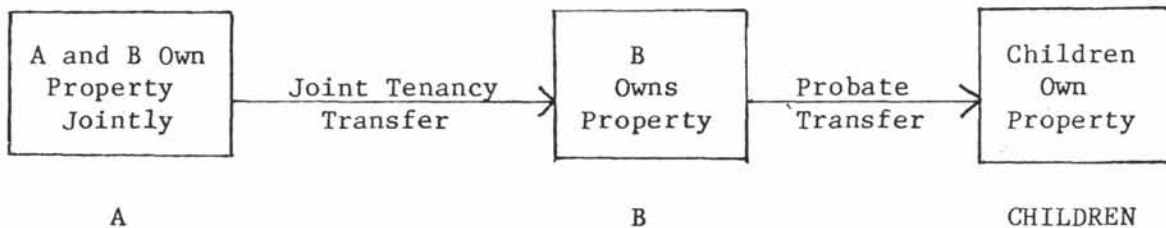
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jointly and have maximum control and utilization of their property. Jointly the couple has the right to mortgage, sell, assign or convey their ownership rights.

At the death of a joint tenant, the property transfers immediately to the surviving spouse with no probate or time delay. Since the property was jointly held, it is not subject to the Michigan inheritance tax. All the property is exempt from the federal estate tax due to the unlimited marital deduction when property is transferred to the surviving spouse. The surviving spouse retains the property in sole ownership with absolute ownership rights to sell, deed, mortgage or otherwise dispose of the property so held.

Figure 1.

Model I
Tenancy by the Entirety



The model assumes the surviving spouse retained complete ownership of the original estate value and transferred it equally to four children through the probate process. The transfer incurs the typical probate costs and Michigan inheritance tax. If the estate is over \$600,000 it is also liable for a federal estate tax. All transfer costs are deducted before it is received by the children.

The total transfer cost as a percent of estate value ranges from 6.5 percent for a \$200,000 estate to 32.2 percent for a \$2 million estate. An \$800,000 estate incurs a 12 percent transfer cost (Table 1). Transfer costs are modest for a small estate and rise rapidly for a large estate. Since the first estate is transferred free of cost, the total transfer cost is realized during the second transfer. Any estate planning to minimize the tax would concentrate on the second transfer.

Table 1. Model I - Tenancy by the Entirety.

\$800,000 Estate

<u>1st Estate</u>	<u>Total</u>
Joint Tenancy Transfer - \$800,000 Transfer Cost	0
<u>2nd Estate</u>	
Probate Transfer - \$800,000 Transfer Cost	
Probate	\$40,000
Michigan Inheritance Tax	25,600
Federal Estate Tax	35,640
Total	\$101,240
<u>Transfer Cost</u> - Both Estates	\$101,240
Percent of Estate	12.7

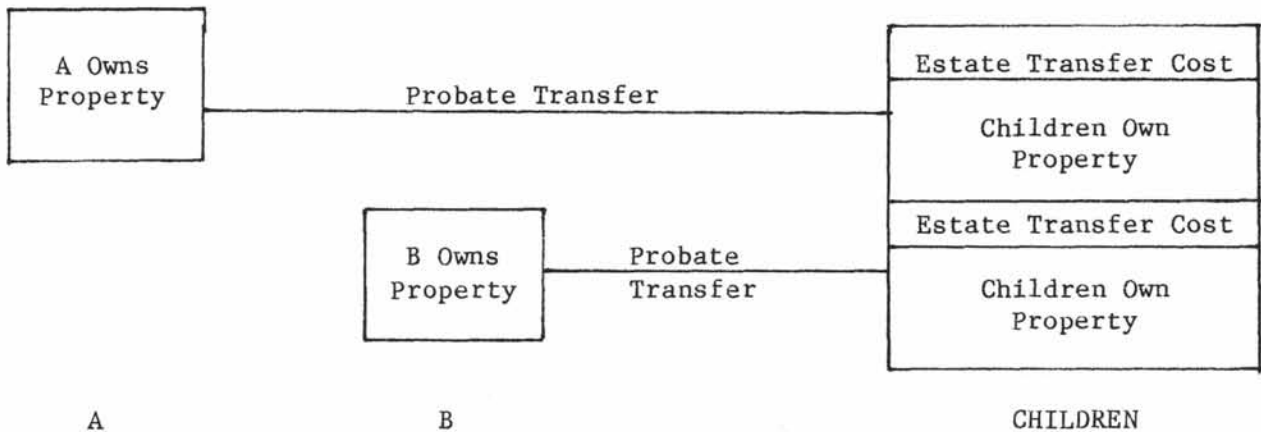
Model II - Tenancy in Common

Model II shows a tenancy in common property ownership by a married couple (Figure 2). Each tenant has the right to mortgage, sell, assign or convey their undivided share in the property. The characteristics and transfer plan are identical in cases where each spouse owned one-half of the property in sole ownership rather than a common interest in property.

At the first death, the tenant's one-half interest is transferred directly to the four children through probate procedures and by-passes the surviving spouse. The estate is subject to the probate costs and Michigan inheritance tax. If the estate is over \$600,000, it is liable for the federal estate tax. All transfer costs at the first transfer are deducted before the children inherit the property.

Figure 2.

Model II
Tenancy in Common



The surviving spouse retains the original common interest with absolute rights to sell, deed, mortgage or other wise dispose of the property so held during lifetime. The property is transferred to the four children through probate procedures in a manner similar to the first estate. If the property maintained its original value, the transfer cost is identical to the first transfer.

The estate transfer cost in Model II is less than owning property by a couple as tenancy by the entirety. In order to achieve tax savings for the children, the surviving spouse relinquishes ownership, management and control of half the couple's estate after the partner passes away. In a large estate where income needs are satisfied by the surviving spouse's property, this may be a viable plan. Small estate owners may have to consider the surviving spouse's annual income needs before adopting the plan.

Since the estate value is split equally between the spouses and the surviving spouse by-passed with additional property, the federal estate tax is not relevant unless the combined estate for the couple is over \$1.2 million. For all estate sizes, probate expenses and the Michigan inheritance tax are a factor. The combined transfer cost as a percent of combined estate value ranges from 6.1 percent for a \$200, 000 estate to 20 percent for a \$2 million estate. The cost as a percent of the estate value is 7.6 percent for an \$800,000 estate (Table 2).

Table 2. Model II - Tenancy in Common

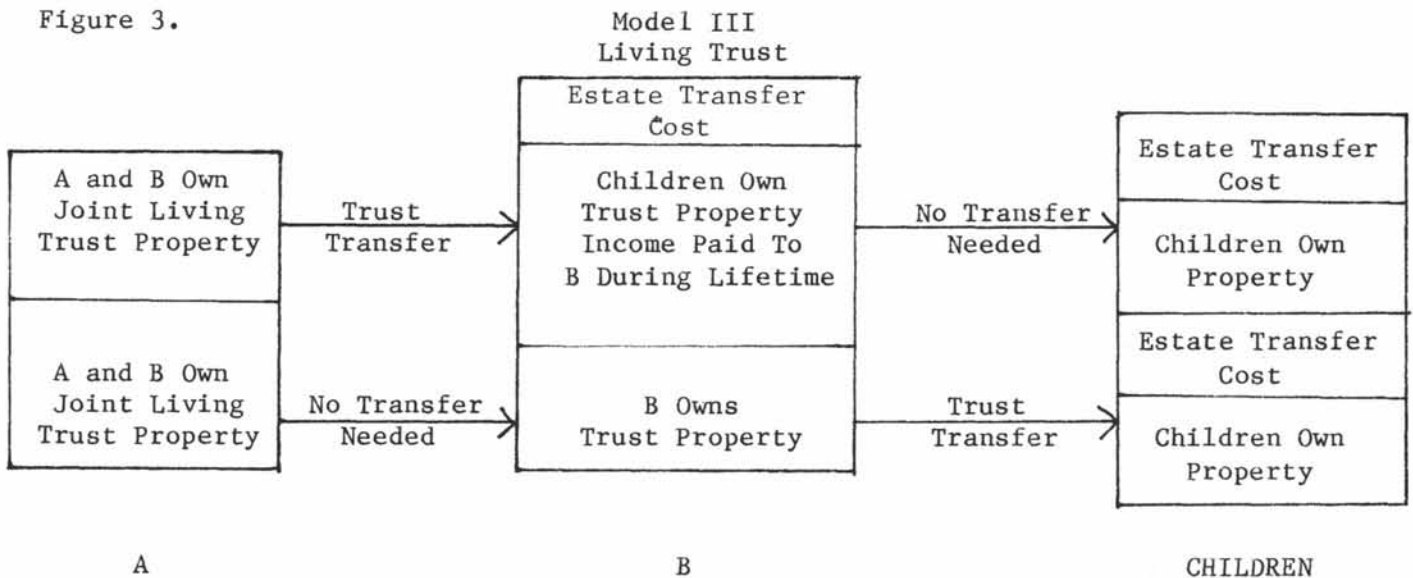
\$800,000 Estate

<u>1st Estate</u>		<u>Total</u>
Probate Transfer - \$400,000		
Transfer Cost		
Probate	\$20,000	
Michigan Inheritance Tax	10,400	
Federal Estate Tax	--	
Total	<u> </u>	\$30,400
<u>2nd Estate</u>		
Probate Transfer - \$400,000		
Transfer Cost		
Probate	\$20,000	
Michigan Inheritance Tax	10,400	
Federal Estate Tax	--	
Total	<u> </u>	\$30,400
<u>Transfer Cost - Both Estates</u>		\$60,800
Percent of Estate		7.6

Model III - Living Trust

Model III overcomes the probable lack of annual income on smaller estates with Model II for the surviving spouse by incorporating a living trust into the estate plan. A married couple during their lifetime create a joint living trust whereby all property is transferred tax free into a revocable trust. During their lifetime, the property is managed and controlled just like they would prior to creation of the living trust. No rights to income or disposition of the property have been given up (Figure 3).

Figure 3.



A trust agreement outlines the ownership rights and distribution of the property. At the death of the first spouse, the trust property is divided into two equal valued trusts. Trust A, a family trust, is created with one-half of the property for the four children's eventual ownership at the death of the surviving parent. During the interim period, the family trust is managed by the trustee (usually a commercial trust department) for the benefit of the family. Annual income is paid to the surviving parent and trust principal invaded if needed for the care, maintenance and support of that individual. Michigan inheritance taxes and federal estate taxes are deducted from the family trust. An annual trust fee is paid from trust income for management of the trust property.

The remaining half of the property is transferred into trust B, a marital trust, for the surviving spouse. The spouse has complete management and disposition rights in the property. Trust B is free of all transfer taxes regardless of value when created due to the unlimited marital deduction for the federal estate tax and the joint ownership of the property for the Michigan inheritance tax. Since the property is titled into the trust, there is no probate transfer.

At the death of the surviving parent, all trust property is distributed to the four children. The family trust is already owned by the children so there is no transfer cost. The property is released to them according to the terms of the trust agreement. Trust B is owned and controlled by the parent, therefore, it is subject to the Michigan inheritance tax and the federal estate tax when transferred to the children.

Model III has a low transfer cost and protection of all the couple's property for the income rights of the surviving spouse. In order to achieve these advantages, the surviving parent gave up management control on half the property to a trustee. The children are prevented from having access to the property during the interim period.

The transfer cost as a percent of estate value ranges from 3.7 percent on a \$200,00 estate to 17.6 percent on a \$2 million estate. An \$800,000 estate incurs a 5.3 percent transfer cost (Table 3).

Table 3. Model III - Living Trust

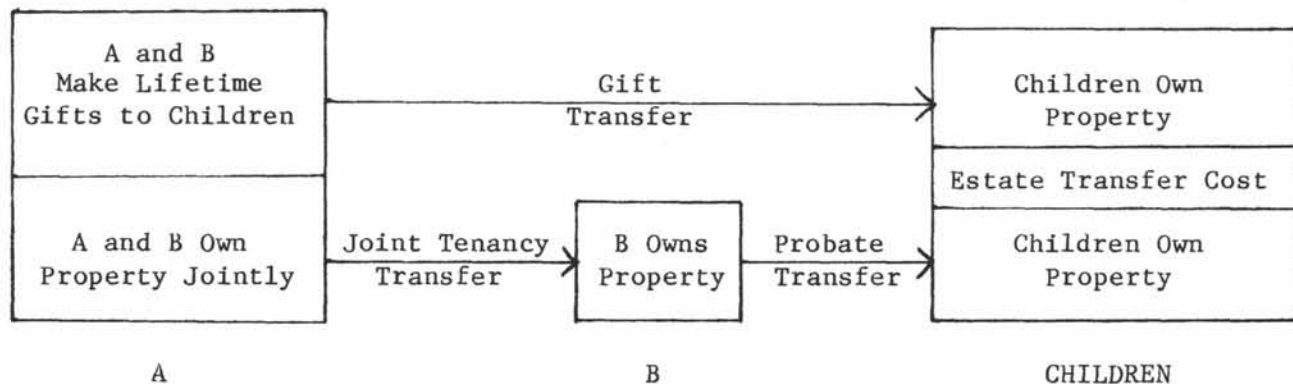
		\$800,000	
<u>1st Estate</u>			<u>Total</u>
Trust Transfer - \$400,000			
Transfer Cost			
Trust Fee	0		
Michigan Inheritance Tax	\$11,200		
Federal Estate Tax	<u>0</u>		
Total			\$11,200
<u>2nd Estate</u>			
Trust Transfer - \$400,000			
Trust Cost			
Trust Fee	\$19,600		
Michigan Inheritance Tax	11,200		
Federal Estate Tax	<u>0</u>		
Total			\$30,800
<u>Transfer Cost</u> - Both Estates			\$42,000
Percent of Estate			5.3

Model IV - Gifts and Tenancy by the Entirety

Model IV parallels the estate plan of model I except gifts are made during the couple's lifetime (Figure 4). Property is jointly held and transferred without cost to the surviving spouse. The surviving spouse owns the property in sole ownership and transfers it through the probate process at death to the four children. Transfer costs are assessed at that time.

Figure 4.

Model IV
Gifts and Tenancy by the Entirety



During the couple's lifetime they give one-half of the property outright to their four children using the \$20,000 annual exclusion per receiver under the federal gift tax law. Over a ten year gift program, a couple can transfer tax free \$200,000 per child or \$800,000 for four children. A larger amount can be given tax free with more years to give and more receivers.

The plan has the advantage of low cost. It assumes the children have stable marriages and financial management skills so the parents' property is not dissipated from family ownership. Couples with a large estate may be concerned about protecting their children from what they regard as a hostile, hedonistic world, and from having "spoiled" their children with too much affluence and too little discipline and be reluctant to make the gifts. For couples with a smaller estate, gifts of half the property may result in too few resources for proving annual income needs for the couple and the surviving spouse.

The transfer cost as a percent of estate value ranges from 3.1 percent on a \$200,000 estate to 10 percent for a \$2 million estate. The transfer cost for large estates is the lowest of any model discussed because gifts of one-half the property during lifetime reduces the estate subject to the federal estate tax. The transfer cost on an \$800,000 estate is 3.8 percent of the estate value (Table 4).

Table 4. Model IV - Gifts and Tenancy by the Entirety

\$800,000 Estate

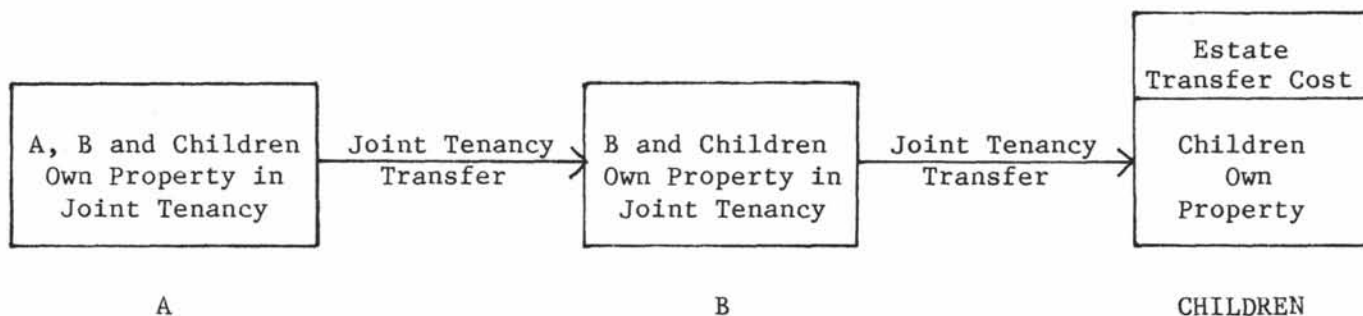
<u>1st Estate</u>	<u>Total</u>
Lifetime Gift Transfer - \$400,000	
Joint Tenancy Transfer - 400,000	
Transfer Cost	0
<u>2nd Estate</u>	
Probate Transfer - \$400,000	
Transfer Cost	
Probate	\$20,000
Michigan Inheritance Tax	10,400
Federal Estate Tax	<u>0</u>
Total	\$30,400
<u>Transfer Cost</u> - Both Estates	\$30,400
Percent of Estate	3.8

Model V - Joint Tenancy

Model V illustrates the use of joint tenancy with rights of survivorship among parents and children (Figure 5). Jointly, the tenants have the right in real property to mortgage, sell, assign or convey their ownership rights. No tenant can individually exercise those rights in real property. In the case of personal property one or more tenants could transfer the property. Since joint tenancy transfers avoid probate and Michigan inheritance tax it is a cost effective transfer plan for estates under \$600,00. Estates larger than \$600,000, however, are subject to the federal estate tax and a Michigan estate tax and the plan results in a relatively high transfer cost.

Figure 5.

Model V
Joint Tenancy



At the death of each parent, the property is vested immediately in the surviving joint tenants. If the estate is larger than \$600,000 at the first transfer, the estate can elect a terminal interest marital deduction for the spouse and avoid federal estate and Michigan estate taxes. However, this option is not open to the children when the last parent passes away and can cause a large tax for large estates.

The plan has the disadvantage of loss of real estate property control for the parents since the children are joint tenants. Also if any of the children predecease other joint tenants, their heirs are disinherited. If a joint tenancy is created in real property, a federal gift tax may be due (or unified credit used) at the point the children's names are added to the deed. The potential gift tax problem with personal property does not exist.

The transfer cost as a percent of estate value ranges from none for estates under \$600,000 to 29.4 percent for estates of \$2 million. An \$800,000 estate incurs a 9.3 percent cost (Table 5). The model appears very cost effective for estates under \$600,000, but very expensive for large estates. Whether the joint tenancy restriction on the parents' control over real estate is worth the cost savings depends upon the family situation.

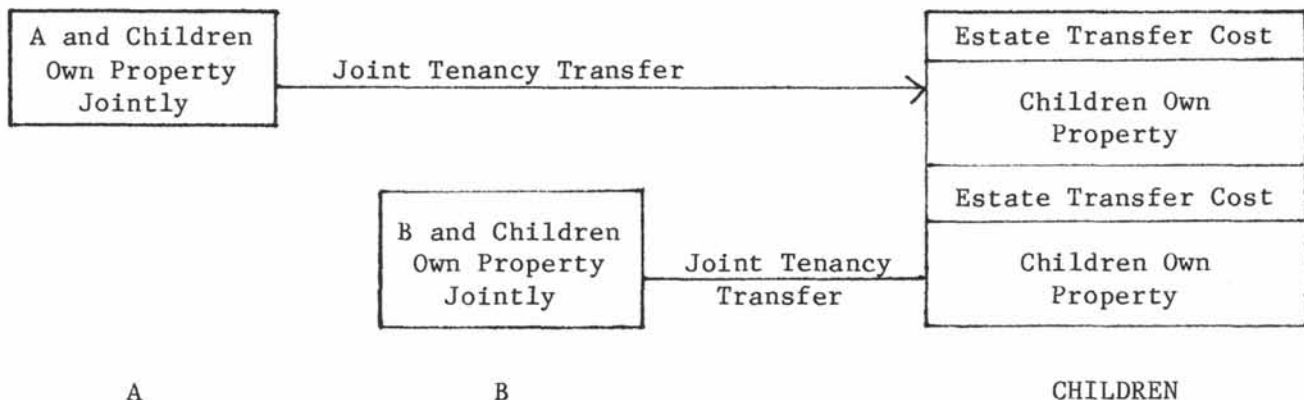
Table 5. Model V - Joint Tenancy
\$800,000 Estate

<u>1st Estate</u>	<u>Total</u>
Joint Tenancy Transfer - \$800,000	
Transfer Cost - None if the estate	
Obtains a Terminal Interest Marital	
Deduction Under the Federal Estate Tax	0
<u>2nd Estate</u>	
Joint Tenancy Transfer - \$800,000	
Transfer Cost	
Michigan Estate Tax	\$25,680
Federal Estate Tax	<u>49,320</u>
Total	\$75,000
<u>Transfer Cost</u> - Both Estates	\$75,000
Percent of Estate	9.3

Model VI - Split Estate Joint Tenancy

Model VI is a variation of Models II and V and incurs some of the same limitations and strengths of those plans (Figure 6). The plan divides the estate

Figure 6. Model IV - Split Estate Joint Tenancy



into equal parts and each parent has their respective share of the estate joint with the children. The decedent's property transfers immediately to the children and bypasses the surviving spouse. Since the property is jointly owned, probate administration costs and Michigan inheritance taxes are avoided. The federal estate tax is not encountered unless the individual estate's are over the unified credit or a combined estate greater than \$1.2 million. The transfer cost as a percent of estate value ranges from 5.3 percent for an estate of \$1.4 million to 15.3 percent for the large estate.

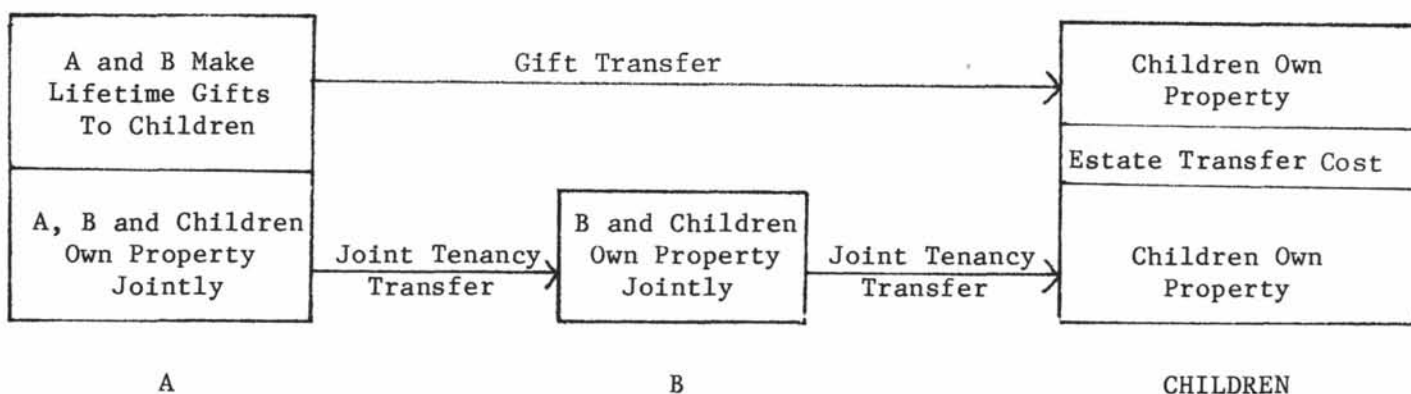
Since one-half the estate by-passes the surviving spouse, annual income needs may be a concern for small estates. The plan also has the same property control issues encountered in Model V in cases where real property is jointly held. The creation of the joint tenancy in real estate may trigger a federal gift tax.

Model VII - Gifts and Joint Tenancy

Model VII combines the estate transfer cost reduction techniques of gifts and joint tenancy (Figure 7). The parents during their lifetime make a gift transfer of one-half the property. Remaining property is owned jointly by the parents and children and transfers immediately without probate administration cost and Michigan inheritance taxes to the surviving joint tenants. The federal estate tax is only a factor for estates above \$1.2 million. The transfer cost as a percent of estate value ranges from 2.6 to 7.7 percent for estates from \$1.4 to \$2 million.

The model has the advantage of low transfer cost and suffers the same disadvantages as previous models when gifts and joint tenancy techniques are used. Couples with small estates may reduce the amount of lifetime gifts in order to conserve annual income needs for the parents. The federal estate tax impact in large estates could be reduced further by the surviving spouse making lifetime gifts to the children.

Figure 7. Model VII - Gifts and Joint Tenancy



Comparison of Estate Planning Models

Tools and Techniques Considered

Since the estate planning models illustrate the transfer of a married couple's estate, the tools and techniques used in the models could be for one or both estates. Only a limited number of commonly accepted estate planning tools and techniques have been considered in the models (Table 6).

They are:

1. Sole ownership is property owned by one individual. During lifetime, that person had absolute rights to sell, deed, mortgage or otherwise dispose of the property so held.
2. Tenancy by the entirety is ownership of property by married individuals with an undivided share in the property. The couple has the right to mortgage, sell, assign or convey their ownership rights. At the death of either party, the remaining individual owns the entire interest in the property as sole owner.
3. Joint tenancy with rights of survivorship exists when two or more persons own an undivided share in the 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 property is immediately vested into the remaining joint tenants with the same rights and responsibility as previously described. In the case where only one joint tenant survives, the property becomes solely owned by the individual.
4. Split estates is a process where the couple divide the estate into sole ownership by each individual. The models assume an equal share is held by each individual. Regardless how a married couple presently owns their property and who provided the consideration in the creation of the estate, the unlimited marital deduction allows a rearrangement of property in any manner between the couple without causing a federal gift tax. Considerable flexibility is now available for a married couple to create split estates and not incur a gift tax impact. The models assume that the individual's property by-passes the surviving spouse and is transferred directly to the heirs so it does not become subject to large death taxes at the second transfer.

Table 6. Tools and Techniques Incorporated in the Estate Planning Models.

Tools and Techniques	Model*						
	I	II	III	IV	V	VI	VII
Sole ownership	X	X		X			
Tenancy by the Entirety	X			X			
Joint Tenancy					X	X	X
Split Estates		X				X	
Living Trust			X				
Lifetime Gifts				X			X

*An X indicates the use of the tool or technique in the model.

5. Living trusts are created by the property owner transferring property in a trust during lifetime. The trust is a fiduciary arrangement in which the trustee holds title to property for the benefit of another. The trust is governed by the trust agreement which details the income, transfer and other rights to the property.
6. Lifetime gifts are transfers of property to a receiver during lifetime without an obligation for the receiver to pay for the property.

None of the models uses the federal estate tax reduction tools of special use valuation or installment payment of estate taxes. In very large estates, these tools become an additional avenue for the personal representative in reducing the federal estate tax burden.

Estate Transfer Methods

The estate transfer models rely upon the following estate transfer methods (Table 7):

1. Probate is a legal procedure to transfer property ownership from a decedent to the heirs. The transfer is directed by terms of the will or state laws if there is no will.
2. Joint tenancy with rights of survivorship (tenancy by the entirety for a married couple) vests immediate ownership in the remaining joint tenants.
3. Living trust transfers are regulated by the trust agreement which directs retained rights and eventual distribution of those rights to the beneficiaries.
4. Lifetime gifts is a transfer of property to a receiver whereby the receiver has immediate use, possession and enjoyment of the property.

Table 7. Type of Estate Transfer Used in the Estate Planning Models.

Estate Transfer Method	Model*						
	I	II	III	IV	V	VI	VII
Probate	X	X		X			
Joint Tenancy	X			X	X	X	X
Living Trust			X				
Lifetime Gifts				X			X

*An X indicates the use of the estate transfer method in the model.

Transfer Cost Comparison

Table 8 summarizes the estate transfer cost as a percent of estate value by planning model. The seven models show widely different transfer costs by estate size. The least expensive transfer cost is associated with models utilizing lifetime gifts (Models IV and VII) where the federal estate tax is a factor and

joint tenancy property ownership with the heirs (Model V-VII). Since lifetime gifts reduces the amount of property subject to the federal estate tax, it is a very cost effective transfer plan. Combine this advantage with the joint tenancy exemption from Michigan inheritance tax and probate administrative costs, Model VII is the best plan possible when only costs are considered.

The split estate between the spouses and estate spousal by-pass increases the effective estate value to twice the unified credit exemption equivalent before a federal estate tax is encountered. Therefore, this tool and others can be a cost effective transfer model.

The trust example (Model III) is especially important for reduction of probate costs, but does little to reduce the Michigan inheritance tax. Any plan utilizing solely owned property by either spouse, results in a probate administration cost and inheritance tax. The use of jointly held property without other tools, is a cost effective plan for smaller estates, but becomes very expensive with larger estates.

Implications for Estate Owners and Planners

The models and the cost comparison for different estate sizes brings out a number of implications for estate owners and planners. The most important implications are briefly covered.

1. The transfer cost impact upon estate transfer is less than ten percent of the estate value (up to \$600,000) for most estate transfer models for small and medium sized estates. Tax reduction is a less important objective in planning estates.
2. The unique estate and family situation combined with the owner's objective become important criteria in a final selection of estate transfer model. Questions about annual income needs for the surviving spouse, property control and management issues, and financial management skills and values of the heirs, vary considerably from one model to another. Personal values and objectives of the property owner become the critical criteria in addition to cost when a transfer model is chosen.
3. The federal estate tax after 1987 is unimportant for estates less than \$600,000 for a decedent. In cases where the couple's estate is split equally between them, the effective estate size is \$1.2 million before tax planning is needed for the federal estate tax.
4. Tax planning for the small estate (\$600,000 or less) should concentrate on the Michigan inheritance tax and probate administration costs. The shift in type of tax planning is a big departure from recent times when the federal estate tax was the burden.
5. Jointly held property ownership (or tenancy by the entirety) resurfaces as a preferred planning tool for small and medium (\$600,000 to \$1.2 million) sized estates. The co-ownership of property through some form of joint tenancy has advantages because of exemptions from Michigan inheritance tax and probate administration costs.
6. In an appropriate family situation, lifetime gifts become the most cost effective method to transfer a large estate (greater than \$1.2 million).
7. The use of living trusts as an estate planning tool is shifted from tax reduction to other family objectives such as maintaining annual income for the spouse, conservation of the estate and property management.
8. The unlimited marital deduction provides a couple with considerable flexibility to rearrange their property ownership and adjust to different estate models as the estate grows and the family situation changes.

Table 8. Estate Transfer Cost as a Percent of Estate Value by Planning Model.

Estate Size (Thou. Dol.)	Model						
	I	II	III	IV	V	VI	VII
	Percent						
200	6.5	6.1	3.7	3.1	---	---	---
400	7.6	6.5	4.3	3.3	---	---	---
600	8.0	7.2	4.9	3.6	---	---	---
800	12.7	7.6	5.3	3.8	9.3	---	---
1,000	18.1	7.8	5.5	3.9	15.3	---	---
1,200	22.5	8.0	5.7	4.0	19.6	---	---
1,400	25.8	10.4	8.1	5.2	22.6	5.3	2.6
1,600	28.4	14.4	12.0	7.2	25.5	9.4	4.7
1,800	30.5	17.5	15.1	8.7	27.7	12.7	6.3
2,000	32.2	20.0	17.6	10.0	29.4	15.3	7.7