Estate Tax Basics: Remember, it’s not “if,” it’s “WHEN” you go!

By Deborah Gaddis Gunter, Ph.D.
Marion, IL
Debbie.gaddis@gmail.com
Estate Tax or Death Tax

The estate tax not a death tax. It is a tax on the transfer of large amounts of money and property.

98% of American estates are not subject to estate taxation—as of an estate tax exemption of $1mm.
What is the impact of Estate Tax on the Federal Treasury?

2003—estimated at $20 billion
Departments of Agriculture, Labor, Commerce, Interior have budgets equal or less than this amount

In 2010, no estate tax
In 2011-12 estimate much less revenue due to exclusion of $5MM
Estate Taxation

- Most wealth in an estate has never been taxed—the wealth is largely due to capital appreciation.
- Estate tax rates are applied on property after the exclusion is applied and after numerous deductions.
How Estate Tax Works

- The gross estate is valued at fair market value (FMV)
Seven Deductions

- Funeral expenses
- Administration expenses
- Debts
- Casualty and theft losses
- State death taxes
- Charitable deductions
- Marital deduction
Seven Deductions

Marital deduction—property interests that pass from decedent to spouse can be deducted from gross estate

i.e., No estate tax on assets going to the spouse!
Estate Tax Basics

- A certain amount of the gross estate is exempt from estate tax—varies by year, currently it’s $5 mm
- If gifts have been made in excess of the annual gift tax exclusion, then the amount of gifts reduce the exemption
Estate and Gift Tax

The estate tax has also become unified with federal gift and generation-skipping transfer taxes such that in 2011 the lifetime gift tax exemption and generation-skipping transfer tax exemption will be $5 million each and the tax rate for both of these taxes will also be 35%.
The estate tax, gift tax and generation-skipping transfer tax exemptions have been indexed for inflation for the 2012 tax year such that each will be increased from $5 million to $5.12 million beginning on January 1, 2012.
Estate Tax Basics

- After all exemptions, then estate tax is due
- Up to 15 years to pay on installment program so no need to liquidate assets immediately
Estate Tax Strategies

- Buy life insurance to pay taxes
- Trusts
- Incorporation
- Generation skipping transfers
- Many, many methods of avoiding estate tax and liquidation of businesses, including farms
Stepped Up Basis

Except in 2010, the basis of the estate’s assets are stepped up to fair market value.

In 2010, limitations on step-up in basis to $1.3 mm. However, 2010 TRA allows election of step-up and estate tax to the 2011 limits--$5mm exclusion and unlimited step up.
Why Step Up Matters

- When assets are sold, the proceeds are taxed at gross value less basis.
- If no step up in basis, the sale may trigger capital gains tax—and AMT.
- With step up, asset can be sold when inherited for no capital gain.
Estate Tax Law is Uncertain

- Estate tax phased out until 2010
- In 2010, tax eliminated
- In 2011, estate tax starts at $5mm ($10 mm/married) with a 35% rate
- In 2013, back to $1mm exclusion, 55% top rate (progressive rates)
Portability

- **Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act** (TRA 2010) allows married couples to add unused exemption of first spouse to die to surviving spouses estate tax exemption
- $10mm passes on tax free
- IRS Form 706 to take advantage
Unlimited Marital Deduction

- There are no limits to what a spouse can give to their spouse tax free
- Not subject to gift tax
- Individuals subject to estate tax may need a AB or QTIP or Qualified Terminal Interest Property Trust to avoid estate taxes.
- A pour over will or trust can put assets into the QTIP.
## Estate Tax Rates

<table>
<thead>
<tr>
<th>Year</th>
<th>Top Estate Tax Rate</th>
<th>Estate Tax Exemption</th>
<th>Top Gift Tax Rate</th>
<th>Gift Tax Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>45%</td>
<td>$2 Million</td>
<td>45%</td>
<td>$1 Million</td>
</tr>
<tr>
<td>2009</td>
<td>45%</td>
<td>$3.5 Million</td>
<td>45%</td>
<td>$1 Million</td>
</tr>
<tr>
<td>2010</td>
<td>0%</td>
<td>Repealed</td>
<td>35%</td>
<td>$1 Million</td>
</tr>
<tr>
<td>2011</td>
<td>35%</td>
<td>$5 Million</td>
<td>35%</td>
<td>$5 Million</td>
</tr>
<tr>
<td>2012</td>
<td>35%</td>
<td>$5.12 Million</td>
<td>35%</td>
<td>$5.12 Million</td>
</tr>
<tr>
<td>2013</td>
<td>55%</td>
<td>$1 Million</td>
<td>55%</td>
<td>$1 Million</td>
</tr>
</tbody>
</table>
Gift Tax

- Apart from gifts to a spouse, an individual can give $13,000 worth of money, goods, or property per year without paying gift tax.
- A married couple can give $26,000/year.
- Up to $5mm total can be given over a lifetime (was only $1 mm) for years 2011 and 2012.
Unified Credit

- Once the $5 mm limit is reached, the taxpayer must begin to pay gift tax.
- Gifts apply against your exemption from estate taxes.
- Gift taxes are not the same as estate taxes.
- Supposed to prevent wealthy from giving assets to family to avoid estate taxation.
Federal Gift Tax Law

The federal gift tax is a transfer tax designed to raise revenues by taxing gratuitous lifetime transfers of net wealth.

Any transfer of value is subject to gift taxation if the person making the gift does not receive something of a similar value in exchange.
Who Pays the Gift Tax

- The person liable for the payment of the gift tax is the individual making the gift.
- A ten year lien attaches upon all gifts made, and if the donor does not pay the gift tax when due, the donee of the gift becomes liable for the gift tax to the extent of the value of his/her gift.
The Annual Exclusion

- The annual exclusion permits the transfer of $13,000 worth of property without the gift tax and without filing a gift tax return.

- The exclusion is doubled for married couples.
Gift Splitting

- A married person with consent of his or her spouse, can give $26,000 per year to as many persons as they desire without a gift tax being due.
- For tax purposes, each spouse is considered to have made one-half of the gift.
- Recipients do not pay gift tax
Marital Deductions

Married persons can make lifetime gifts to each other and take advantage of a marital deduction for any amount without a gift tax.
Transferring Life Insurance Policies by Gift

Example: A father transferred a life insurance policy ownership to his son. Its replacement value was $20,000. An annual exclusion of $13,000 is allowed. The remaining $7,000 is subject to gift taxation.
Gift Tax Charitable Deduction

- Gifts made to recognized charitable, religious, educational and governmental organizations are completely gift tax free.
- No limits on amount given
Business Valuations

- The assessed value of a business may be reduced by minority discounts
- E.g., a lowered value due to the lack of liquidity from shared ownership
- Discounts may be applied for lack of marketability
Ordinarily, properties in an estate must be valued at highest and best use.

In certain circumstances, property may be assessed at current use instead.

Can be used to reduce farm and forestry valuations in an estate.
Special Use Valuation

- Section 2032A of IRC
- Allows farms to be valued at current use rather than highest and best use
- Cannot reduce estate by more than $1,020,000 in 2011 (indexed for inflation each year)
- Only for woodlands considered businesses, not investment
Section 2032A

- Many restrictions
- Heirs must be certain defined family members
- Owned at least five of 8 years by decedent who has equity interest and must have been used for timber growing by decedent or family member (see Siegel for details)
Section 2032A

Adjusted value of the real and personal property getting special use valuation must comprise, at FMV, at least 50% of adjusted value of decedent’s gross estate, with at least 25% being qualified real property
Section 2032A

- Recapture of estate tax if property no longer farmed/managed as forest business for 10 years
- This is not a do-it-yourself option—seek professional advice before relying on this!
Bottom Line

- Much estate tax can be avoided with prior planning
- When estate tax revenues are eliminated, some revenues must be obtained elsewhere if deficit is to be addressed
- Good source of basic info: www.about.com and search for estate planning