March 04, 2005

An Overview Of The Federal Estate Tax And Related Planning Techniques

This article summarizes the operation of the federal estate tax and describes two proven techniques which can be used to reduce or eliminate the tax. While all of the points covered may not apply to your personal situation, we hope you will find this summary helpful.

Estate and Gift Taxes Combined into a "Unified" Tax System
Prior to 1977, the federal gift tax and the federal estate tax were independent taxes, each having its own personal exemptions and tax rates. Beginning January 1, 1977, that system was replaced with a system in which lifetime gifts and transfers at death are combined and taxed under a single rate schedule. The personal exemptions of the prior law were replaced with what is now known as the "applicable credit amount". The applicable credit amount currently equals the tax on $1,500,000, i.e. $555,800. The practical effect of this is that no tax is due on the first $1,500,000 of transfers, whether made by lifetime gifts or at death.

An example may help clarify how the applicable credit amount works: Assume that $800,000 of taxable gifts were made after 1976 and the donor's taxable estate is $950,000, for a total of $1,750,000. (Any other combination of gifts and taxable estate totaling $1,750,000 would produce the same result). The tax tables indicate that the "tentative" tax on $1,750,000 is $668,300. The applicable credit amount is subtracted from the tentative tax, and the difference is the amount of tax payable ($668,300 - 555,800 = $112,500). For the balance of this discussion, we will treat the applicable credit amount as equaling the tax on $1,500,000. It should be noted, however, that as a result of the 2001 Tax Act, the applicable credit amount is scheduled to increase to equal the tax on $2,000,000 in 2006 and then $3,500,000 in 2009.

The Gross Estate
The assets that are included in a person's gross estate are broadly defined and include some things that people tend to overlook when estimating the size of their estates. The gross estate includes assets owned by the decedent at the time of death, as follows:

1. Real estate;
2. Stocks and bonds;
3. Cash and deposit accounts;
4. Partnership interests;
5. One-half of joint property held with a surviving spouse and 100% of joint property held with other parties unless the surviving joint tenant can prove that he or she furnished the funds used to acquire the asset;
6. The decedent's retirement plans and IRA accounts;
7. Life Insurance policies over which the decedent had incidents of ownership (*e.g.* the right to change beneficiaries or borrow against the policy);

8. Tangible personal property (jewelry, cars, furniture, etc.)
9. All other assets owned by the decedent.

The items in the list above are all assets over which the decedent had ownership or control, so it seems logical that they would be included in the estate. What may be surprising, however, is that the taxable estate may even include assets which the decedent no longer owned. For instance, if life insurance was transferred within three (3) years of the date of death, the insurance proceeds are included in the taxable estate. Likewise, if a person transferred assets to a trust and retained certain powers (e.g. the right to change the beneficiaries) the assets will be included in the taxable estate, even if the decedent is not a beneficiary of the trust. Thus, the taxable estate may include assets over and above those that would normally be included in a person's financial statement.

For married couples domiciled in Wisconsin, the Marital Property Act may complicate the determination of what assets are part of the gross estate. Under the Act, which took effect January 1, 1986, title no longer controls ownership of property owned by married persons. For instance, a paycheck issued in the name of one spouse constitutes marital property and actually belongs 50% to each spouse. Some portion of assets held in the name of the decedent may actually belong to the other spouse and be excluded from the estate. On the other hand, some portion of assets titled in the name of a surviving spouse may actually belong to the decedent and be included in the taxable estate. A personal representative has the task of reviewing the assets owned by the decedent and the surviving spouse and determining what interest the decedent had in each of those assets on an item by item basis. (One way to simplify this process is for the spouses to enter into a Marital Property Agreement by which they agree how their assets are owned and classified.)

Once the assets included in the gross estate have been identified, they must be valued. Generally, they are valued at fair market value as of the date of the decedent's death. In some cases, it is possible to elect to value them six (6) months later (the "alternate valuation date") if the market value of the estate has declined and the election will actually reduce estate taxes payable.

Deductions

The law permits several types of deductions from the gross estate. Five (5) types of deductions may be claimed by all estates: 1) The decedent's debts, mortgages and liens; 2) funeral expenses; 3) expenses of administration of the estate; 4) casualty losses during administration; and 5) gifts to charity, either outright or in a qualifying trust.

There is a sixth kind of deduction, available only if the decedent was married, which is known as the "marital deduction". Property passing outright to a surviving spouse or to a marital trust may be deducted from the gross estate. There is no limit on the amount of the marital deduction, so no tax is due on qualifying transfers between spouses, no matter how large the estate may be. The law has strict requirements as to which trusts qualify for the marital deduction. A marital trust must operate for the exclusive benefit of the surviving spouse. During his or her lifetime, all of the trust income must be paid to the spouse and there can be no other beneficiaries. Upon the death of the spouse, the assets of the marital trust are included in the spouse's taxable estate.

A recent change in the tax law denies the marital deduction for property passing to a spouse who is not a citizen of the United States unless that property is placed into a special kind of trust know as a "qualified domestic trust." Such a trust is designed to insure that the assets will eventually be subject to U.S. tax.

Computation of the Tax
To summarize, we started by totaling the value of assets included in the gross estate and then deducted from that figure debts, funeral expenses, administration expenses, losses, the charitable deduction and the marital deduction, if any. The net figure after subtracting all of these items is known as the taxable estate. If the taxable estate plus taxable gifts made after 1976 total the applicable exclusion amount or less, no tax is due and no estate tax return is filed. On the other hand, if the total exceeds the applicable exclusion amount, the applicable credit amount will be used completely and tax is imposed on the amount over the applicable exclusion amount at rates starting at 45% and climbing to 48% on transfers of $2,000,000 or more. With these tax rates, huge amounts of tax can be due. For instance, on the estate of a decedent dying in 2004 with $2,000,000 passing to children or other non-spousal beneficiaries, the combined state and federal tax will be approximately $225,000. On an estate of $3,000,000, the tax will be approximately $705,000, and on an estate of $4,000,000 the tax will be approximately $1,185,000.

Planning to Minimize the Impact of the Estate Tax
There are several proven techniques which can be used to reduce the impact of the estate tax. Two commonly used techniques are described below.

Tax-Free Gifts
One technique is the use of tax-free gifts to reduce the size of the taxable estate. Federal law permits a person to make tax-free gifts of up to $11,000 per year per donee to an unlimited number of donees. Gifts of less than $11,000 per year do not require the filing of a gift tax return and do not use any of the applicable credit amount. (Some gifts in trust do not qualify for this $11,000 exclusion.) Married couples are entitled to use "gift splitting" to treat gifts made by one spouse as though they were made one-half (1/2) by each spouse, so that they can give a total of $22,000 per donee per year tax-free.

In addition to these annual gifts, the law excludes from taxation gifts paid directly to institutions to provide for medical or educational expenses of a beneficiary. Thus, tuition or medical bills can be paid for a beneficiary in addition to an $11,000 annual gift. In order to qualify for this treatment, however, the payment must be made directly to the school or health care provider. If you give the money to the beneficiary, the gift will not qualify under these rules, even if the beneficiary actually uses the funds to pay medical bills or tuition.

Gifts to charities constitute a third type of tax-free gift. By making tax free gifts, significant amounts of property can pass to your beneficiaries without paying any tax on those transfers.

Family Trust Planning
As mentioned above, there is no limit on the amount of the marital deduction. This serves as an invitation for a person to leave his or her entire estate to the surviving spouse, since there will be no tax due no matter how large the estate may be. This seems like a natural and reasonable thing to do. In many cases, however, it is an expensive way to dispose of property because of the taxes that may be incurred later. As an alternative, we frequently recommend the creation of a trust which bypasses the surviving spouse's estate. Such a trust may be called a Family Trust, a Bypass Trust or a Credit Shelter Trust. Whatever it is called, it works by removing the trust assets from the taxable estate of the surviving spouse. The charts accessed by clicking on the “Exhibit” links in the next paragraph illustrate the use of this technique.

Exhibit 1 shows the tax result of leaving everything to the surviving spouse in a case where the deceased spouse has an estate of $2,000,000 and the other spouse has no assets. (Although this is an unrealistic fact situation, it simplifies the illustration.) In Exhibit 1, there would be no tax due on the first estate because of the marital deduction. However, if the surviving spouse also dies in 2004, assuming that all of the assets are still owned by the survivor, $1,500,000 would be covered by the survivor's applicable credit amount and the tax on the balance would be approximately $225,000. A net estate of about $1,775,000 would pass to the children. Exhibit 2 illustrates the use of a family trust in the same fact situation. If the first spouse leaves $1,500,000 to the family trust and gives the balance to the surviving spouse, there will still be no estate tax due on the first estate because the applicable credit amount plus the marital deduction will eliminate the tax. Under the terms of the family trust, the survivor may have full economic benefit of the assets, but some restrictions are placed on those assets so they are not included in the survivor's taxable estate. At the time of the survivor's death, the survivor's estate would only be $500,000 and, because of the survivor's applicable credit amount, no tax would be due. Using this technique, the entire $2,000,000 can pass tax-free to the children, producing a tax savings of about $225,000. If the couple 's assets exceed $3,000,000, some tax might be due on the second estate, but payment of the tax will have been deferred until the second death and the tax will have been minimized.

A bypass trust is most commonly used with married couples, but this technique will also work for unmarried individuals. For instance, a person may want to provide for an elderly parent but not want to increase the parent's taxable estate. The parent could be the beneficiary of such a trust, which would terminate upon the parent's death, with the assets going to some other beneficiary. The trust assets would not be part of the parent's taxable estate and no death taxes would be due with respect to those assets.

Wisconsin and Illinois Estate Tax

Although this article focuses on federal taxes, a mention of Wisconsin and Illinois taxes is also appropriate.

Wisconsin abolished its inheritance tax in 1992. Until recently Wisconsin imposed an estate tax which equaled the state death tax credit allowed on the federal estate tax return. However, in response to the 2001 Tax Act, the Legislature passed a law which in effect freezes the Wisconsin exemption at $675,000. As a result, some Wisconsin tax will be due on taxable estates larger than $675,000 even if there is no federal estate tax due.

Until 2003, Illinois had an estate tax equal to the state death tax credit allowed on the federal estate tax return. Only estates that owed federal tax owed Illinois tax, and the full tax paid to Illinois was allowed as a credit against the federal tax. For estates of individuals dying in 2003 and later, the rules will change. With one exception, the rule remains that only estates that owe federal tax will owe Illinois tax, but the amount those estates will owe to Illinois will be greater than the credit those estates may take against the federal tax. The net effect is an increase in the total tax due.

The one exception involves estates of individuals dying in 2009 with estates between $2 million and $3.5 million. Those estates will owe Illinois tax even though no federal tax is due.

Questions?

This article is not intended to be a complete discussion of the estate tax law and many rules applicable to special situations are not discussed. If you have questions or if there are circumstances which may make your personal situation unusual, we invite you to discuss these matters with us.

For more information, please contact Gordon K. Miller at gkmiller@michaelbest.com or 414.225.4930**.**

Michael Best