Chapter 4: The Federal Estate Tax

The federal estate tax is the most important tax that drives estate planning. With a beginning marginal tax rate of 37% increasing to a maximum 50% marginal tax rate, the tax imposes a serious burden on many estates. This chapter explores the manner in which the tax is calculated.

Chapter 4:

- The Gross Estate
- Alternate Value of Property
- The Marital Deduction
- The Marital Deduction Trust
- Qualified Terminable Interest Property
- Credits Against the Federal Estate Tax
- The Unified Credit
- Computing the Federal Estate Tax
- Filing the Federal Estate Tax Return

> *"There is one difference between a tax collector and a taxidermist — the taxidermist leaves the hide."*
>
> *Mortimer Caplin, former IRS Commissioner*

The federal estate tax is imposed on the estate of a person who was a citizen or resident of the United States at the time of death. The federal estate tax can be the heaviest cost imposed on an estate.

The present estate tax system was put into effect in 1976. At that time, federal estate taxes were **unified** with gift taxes on lifetime gifts. This means that gifts (other than annual exclusion gifts) made by an individual during his lifetime are added back into that person's estate at death for purposes of computing the estate tax. By unifying the tax system on gifts during life with those made at death, the new laws lessened the incentive of making major lifetime gifts for the sole purpose of reducing a person's estate and consequently reducing the estate taxes.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made significant changes in the federal estate tax.

The estate tax law changes consist of increases in the unified credit amount, a reduction in the highest tax rate from 55% to 50% with further reductions in the tax rate over time, a complete phase-out of the tax for one year and then re-institution of the estate tax using 2001 law.

During the one year period that the estate tax is phased out (2010), stepped up basis is eliminated and replaced with **carryover basis.** This means that persons inheriting property will not get a new basis equal to the date of death value and will have to pay capital gains on sale of the property. There is a fixed exclusion amount for transfers to a spouse and other beneficiaries. This is not discussed in detail in this book because it is so far out and so many things can happen over the next decade. It is important to keep this in mind in evaluating an estate for tax planning. You can expect that what the government gives with one hand, it takes away with the other.

These changes, along with the complete reinstatement of the estate tax on January 1, 2011, make it very difficult to do long term estate tax planning. Dramatic swings from huge projected budget surpluses that vanish to be replaced by budget deficits make it imprudent to guess as to what may happen. However, it appears likely that there will be further changes in estate taxation before the expiration of the new law. The prudent approach is to establish an estate plan that focuses on just the next three to four years, revisiting the plan at that time to determine what changes, if any, need to be made.

The tax calculations in this Chapter are based on a unified credit of $1,000,000. Future increases in the credit will, of course, reduce the federal estate tax. As a rough guide to the effect of changes in the unified credit, when the credit goes to $1,500,000 in 2004, the FET will be reduced by about 42%, reducing the tax due by approximately $210,000.

Observation

Applicable Exclusion Amount

The phrases Applicable Exclusion Amount and Unified Credit are frequently used interchangeably. The Applicable Exclusion Amount is the amount of property protected from estate taxes and was a new term used in the latest tax law. The Unified Credit is the amount of taxes that would have to be paid on the Applicable Exclusion Amount if there was not a Unified Credit. The phrase Unified Credit will over time probably pass out of existence because the estate tax and gift tax credit are no longer unified with the estate tax credit scheduled to rise and the gift tax credit limited to $1,000,000.

Does this sound confusing? It is even for experienced estate planning attorneys. For purposes of this book, we will use the phrase Unified Credit which means both.

> Putting assets in the joint names of a parent and child does not reduce estate taxes. While the property may avoid probate, the distribution to one child may leave the other children without their share of the joint asset. Always know all of the consequences when you are adding on a co-owner to your property.

The federal estate tax is based on the amount of the **gross estate** of the decedent and is calculated after the allowance of certain deductions and credits. The estate tax on estates that exceed the applicable amount (the unified credit) in value can be quite severe.

In order to understand how the tax impacts each of us at death, several concepts must be understood.

THE GROSS ESTATE

First, before estate taxes can be addressed, the value of the assets in the estate must be determined. The tax system imposes a tax on the gross estate of a decedent less all deductions. The term gross estate has a special meaning for the federal estate tax (FET) law. Here are some assets that are typically included in the determination of a gross estate:

- The value of all interests in property owned by the decedent at the time of death, including:
  - Real Estate
  - Life Insurance Proceeds
  - Automobiles
  - Jewelry
  - Furniture
  - Stocks and bonds
  - Bank accounts, CD's
  - Personal effects
  - Savings bonds
  - Stock options
  - IRAs and 401(k)s
  - Business Interests
  - Annuities
- The decedent's interest in property held as a **joint tenant with right of survivorship**. If the decedent's joint tenant is his spouse, generally only one-half of the property is included in the decedent's gross estate. However, if the joint tenant is someone other than his spouse, there is a presumption that the decedent owned the entire property, although the decedent's estate may rebut the presumption by showing contribution by another joint tenant.
- Certain **transfers of property within three years of death** including interests in life insurance policies, transfers where the decedent has retained an interest and transfers of property where the decedent retained the right to revoke the transfer.
- Property subject to a **general power of appointment** held by the decedent. A power of appointment is a power held by an individual that allows that person to direct, without limitation, who should enjoy and receive the property that is controlled by the power. It is unusual for a person to have a general power of appointment over property unless that person is a beneficiary of a will or trust that, for estate planning purposes, creates the power in the beneficiary.
- The death benefit paid on **life insurance policies** when the decedent either owned the policy or had "incidents of ownership" associated with the policy.

The concept of the gross estate as used for FET purposes is very broad and encompasses all of a person's property interests. The following example illustrates how the gross estate is determined.

For purposes of the FET, Michael's gross estate is determined as follows:

- One-half of the residence is included because it is held jointly with his spouse. The law presumes that a husband and wife have equal ownership of property held jointly.
- The total values of the furnishings, personal possessions and the automobile ($30,000) are included in his estate.
- The $150,000 death benefit of the life insurance is included because Michael owned the policy.
- The value of the rental property is included in Michael's estate except to the extent that the estate can establish contribution by his brother, Barry, as the joint owner. The estate has the burden of proving the amount of any contributions made by Barry, such as amounts Barry may have paid towards the down payment or for any improvements. Compare this to Michael's interest in the

Example Part 1

At the time of Michael's death, he owned the following property:

Description	Value
• Residential real property owned as joint tenants with right of survivorship with his spouse, Janice.	$350,000
• Interests in furnishings and personal possessions such as jewelry and clothing.	$20,000
• Automobile.	$10,000
• Death benefit of life insurance owned by Michael on his life.	$300,000
• Rental property held as joint tenant with right of survivorship with his brother, Barry.	$150,000
• IRA with Janice as beneficiary.	$200,000
• Stock held in brokerage account as joint tenant with right of survivorship with Janice.	$295,000
• Checking and savings accounts held with Janice as joint tenants with right of survivorship.	$125,000
Total estate:	***$1,450,000***

Example Part 2

For FET purposes, Michael's estate is recapitulated as follows:

Description	Value
• Residential real property owned as joint tenants with right of survivorship with his Janice (one-half value).	$175,000
• Interest in furnishings and personal possessions such as jewelry and clothing.	$20,000
• Automobile.	$10,000
• Death benefit of life insurance owned by Michael and on his life.	$300,000
• Rental property held as joint tenants with right of survivorship with Barry (presume that brother could not show any contribution).	$150,000
• IRA with Janice as beneficiary.	$200,000
• Stock held in brokerage account as joint tenants with right of survivorship with Janice (one-half value).	$147,500
• Checking and savings accounts held with Janice as joint tenants with right of survivorship (one-half value).	$62,500
Total Gross Estate:	**$1,065,000**

residence with Janice, which is automatically included at 50%, not 100%. When property is owned jointly with someone other than a spouse, for instance a child, the presumption is that the decedent owns the entire interest, except if contributions by the co-owner can be established.

- The entire amount of the IRA is included in the estate for estate tax purposes (It is also subject to income taxes when withdrawals are made.)
- Only one-half of the stock and one-half of the balance of the checking and savings accounts are included because, again, they were held as joint tenants with Janice. The presumption of equal ownership of property owned jointly between a husband and a wife applies to all types of property.

ALTERNATE VALUE OF PROPERTY

The value of property included in the gross estate is its fair market value at the date of death. However, the executor of the estate can elect to use the **alternate value** of the property for the purpose of computing the estate tax liability. Alternate value is the fair market value of the property six months after the date of the decedent's death.

For example, presume that the price of stock owned by a person dramatically fell following the date of death. The executor can decide, after balancing estate tax and income tax considerations, whether or not to use the lower value of the stock at the six month mark after the decedent's death for purposes of the estate tax return. If an alternate value is used for one asset in the estate, it must be used for all assets in the gross estate (the executor cannot pick and choose among the assets). The election to use alternate values is irrevocable and must be made on the estate tax return. Also, the election can only be made if it has the impact of **reducing** the estate taxes.

At first blush, using the alternate value, seems attractive if there is a drop in the value of the estate property over the six month period following death. However, this value is also considered the new cost basis of the estate property in the hands of the beneficiaries. This could result in greater capital gains or income taxes being paid if the property is sold. The entire estate tax rate should be compared to a possible capital gain being incurred upon the sale of the asset. These competing tax objectives must be taken into consideration.

Observation

If no estate taxes are due at death, there is no incentive to use the alternate value of the estate property. This occurs most commonly where there is a surviving spouse and the property passes to that person or where the size of the estate is less than the unified credit amount.

DEDUCTIONS FROM THE GROSS ESTATE

The next step in calculating the FET is to reduce the gross estate by any allowable deductions. These deductions are generally summarized as follows:

- The **executor's commission or trustee fees** for acting as the fiduciary of the decedent's probate estate and/or successor trustee of the decedent's trust. These fees are treated as ordinary income to the executor or successor trustee. Frequently, when the executor or trustee is a beneficiary of the estate, he or she will waive the fees and instead simply take the share allocated to them under the Will or trust.
- Fees paid by the executor or successor trustee for the employment of an **attorney** to assist in the administration of the estate.
- **Miscellaneous expenses** such as fees to employ appraisers, accountants, court filing expenses related to probate administration, property transfer costs and all related expenses that were incurred as part of the administration of the estate.
- The **debts of the estate,** including the decedent's final medical expenses, funeral bill, unpaid mortgages, credit card bills and other legal obligations of the decedent that were incurred prior to death.
- **Charitable gifts** to organizations that are recognized charitable organizations.
- An **unlimited marital deduction** for all property passing from the decedent either directly to a surviving spouse or to certain types of trusts held exclusively for the surviving spouse's benefit.

THE MARITAL DEDUCTION

The marital deduction is the most important deduction available for married couples. It is unlimited in amount and can be

used to defer all estate taxes until the death of the surviving spouse.

Property passing directly to a surviving spouse qualifies for the marital deduction (as long as the spouse is a U.S. citizen). For example, all property interests transferred from the decedent's estate directly to the surviving spouse qualify for the deduction. Consequently, if you leave everything to your surviving spouse, without restriction, it will qualify for the marital deduction and eliminate the FET for your estate. Bear in mind that when the surviving spouse dies, there may be a FET on the assets remaining in her name. This is why the marital deduction is often referred to as a device to defer all estate taxes until both spouses are deceased. As a result of this tax deferral, the surviving spouse has all of the resources saved during the marriage available for her support, without any diminishment through the imposition of estate taxes.

The marital deduction is unlimited in amount, meaning that no matter the value of the property passing to the surviving spouse (be it $100,000 or $10,000,000), there are **no estate taxes**.

If the surviving spouse is a not a U.S. citizen, then the unlimited marital deduction for estate taxes is not available. However, taxes on property held in trust for a non-U.S. citizen spouse can be deferred if the property passes to a special trust, called a Qualified Domestic Trust (QDOT), for the benefit of the surviving spouse. It is crucial for non-U.S. citizens to confer with an estate planning attorney to make sure that the assets can pass to a surviving spouse without being diminished by estate taxes through the use of a QDOT.

FET law provides a few methods by which a person may pass an interest in property to be held for the benefit of a surviving spouse (besides an outright gift) and still have that property qualify for the marital deduction. There are two ways of doing this: the **marital deduction trust** and the **QTIP trust.**

THE MARITAL DEDUCTION TRUST

A person may transfer property into a trust, either during his lifetime or at death, and if that property is held for the **exclusive benefit** of the surviving spouse, that property will qualify for the FET marital deduction. Generally, a marital deduction trust will provide that the surviving spouse is entitled to the following benefits from that trust:

- **All of the income** from the trust.
- **Discretionary principal** for the spouse's health, support, maintenance and education.
- The **right to withdraw** the entire principal of the trust at any time and to designate whom shall receive the property after the death of the surviving spouse. This right gives the surviving spouse absolute control over the final disposition of the trust.

This type of trust is commonly established as a part of a sophisticated estate plan to minimize FET. The surviving spouse has unlimited access to the funds in the trust. Any property in the trust will pass on first as the surviving spouse decides and, to the extent he or she does not make an election, to the beneficiaries chosen by the first spouse to die, without going through probate on the death of the surviving spouse.

The assets in this type of trust are included in the surviving spouse's taxable estate on his or her death. Again, the unlimited marital deduction serves to defer (not eliminate) estate taxes until the death of the surviving spouse. The reasons for establishing a marital deduction trust, also commonly known as "Trust A," are discussed in Chapter 12 The A-B Trust Strategy. A comprehensive estate plan uses a marital deduction trust to its full potential if the wealth of the couple dictates the use of a marital trust.

QUALIFIED TERMINABLE INTEREST PROPERTY

What if there is a second marriage situation and the husband wants to provide for his second wife, but not give her absolute control over the final disposition of the property? The husband can set up for the benefit of the wife (or conversely, a wife can establish for the benefit of a husband) a marital deduction trust that is similar in nature to the trust described above except that the surviving spouse is not given the right to withdraw the principal of this trust or name new beneficiaries. On the death of the surviving spouse, the property passes on to other beneficiaries named in the trust by the spouse who established the trust. This type of a trust is known as a **Qualified Terminable Interest Property** trust (QTIP trust). Its significant feature is that the surviving spouse does not have a withdrawal right, restricting the surviving spouse's control of the property. A QTIP trust allows a person to achieve multiple benefits including the following:

- Provide funds for his spouse's support following his death.
- Use the marital deduction against estate taxes for the property put into the trust to defer estate taxes.
- Guarantee that the property remaining in the QTIP trust after the surviving spouse's death passes on to the beneficiaries chosen by the spouse who established the trust.

This type of trust is frequently used where the trust donor has children from a prior marriage and wants to make sure that after the death of his current spouse, his assets will pass on to his children. By creating a QTIP trust, the donor can achieve all of the above goals. His spouse gets the use of the money for support and he insures that the remaining trust property on the death of his spouse will eventually go to his children.

In these circumstances, it is crucial to name an independent person or bank, someone other than the spouse, as the trustee of the QTIP trust. Naming either the spouse or one of the donor's children as the trustee presents obvious conflict problems regarding how the property can be used for the surviving spouse's benefit. This is a situation where a corporate trustee, with total independence, is recommended.

A QTIP trust is also a valuable tool when the donor wants to protect his spouse from financial misfortune or questions her ability to handle the trust fund. With careful drafting, the QTIP trust can protect the trust principal from the claims of creditors. A spouse who is a beneficiary of a QTIP trust still has the right to receive all of the income of the trust and discretionary principal as needed for her support. However, she does not have a right to withdraw the principal of the trust at anytime and can only receive the principal if, in the opinion of the trustee, it is needed for support. Again, this highlights the importance of selecting an independent trustee who can make this decision in a reasonable, balanced manner.

A third situation when a QTIP trust is useful is when spouses want to make sure that both of their exemptions from the generation-skipping transfer tax are used. This is a complex technique that enhances the dynasty planning aspects of an estate plan.

In a nutshell, the usefulness of a QTIP trust is that while it qualifies for the unlimited marital deduction (thereby postponing estate taxes) it also limits the surviving spouse's access to the trust property.

CREDITS AGAINST THE FEDERAL ESTATE TAX

After reducing the gross estate by the foregoing deductions, the **tentative FET** is calculated. The estate tax rates are applied against the amount of the estate less the deductions. The estate is then allowed to deduct certain credits from this tentative tax. Before we go further, let us review the difference between deductions and credits.

A **deduction** reduces the amount of the gross estate for tax purposes. As an example, assume the decedent's gross estate is $1,700,000 and there is a $6,500 funeral

expense. The funeral bill is a deduction that reduces the gross estate to $1,693,500 for purposes of calculating the estate tax.

By comparison, a **credit** is a direct dollar for dollar reduction of the amount of the tax. Using the above example, the tentative estate tax on a taxable estate of $1,693,500 is $642,875. The amount of the unified credit available in 2003 is $345,800 which reduces the tax to $297,075.

In summary, deductions reduce the gross estate before calculating the estate tax. Credits reduce the estate tax that is due. Because of this, credits create a greater tax saving opportunity than deductions.

The most significant credits against the FET are the following:

- A **unified credit** against the FET. This is a direct reduction in the amount of the FET up to the amount of the credit.
- A **state death tax credit** against the FET for taxes paid to a state. The estate tax systems for states is discussed in Chapter 6 State Estate and Inheritance Taxes.

There are several credits that are of lesser importance, either because they are used less frequently or are smaller in value. Primarily, these are tax credits for taxes previously paid on certain gifts and a credit for estate taxes paid on prior transfers. They are mostly applicable if people die in quick succession.

THE UNIFIED CREDIT

The unified credit is generally considered to be the most important tax credit because it is available to every person and is probably the largest credit. The credit protects a certain amount of property from estate taxes, no matter who is the beneficiary of the property. The protected property does not have to go to a surviving spouse (unlike the marital deduction). This property can pass to children, nieces, nephews, other relatives, friends, or trusts established for these individuals.

The unified credit may effectively wipe out the entire FET liability. In 2003, an estate of $1,000,000 would have a FET of $345,800. This is precisely the same amount of the unified credit available to the decedent. Therefore, there is no FET because the credit eliminates it.

The table shows the Applicable Exclusion Amounts and the equivalent Unified Credit for each of the years covered by the law.

Applicable Exclusion Amount With Unified Credit Equivalent

Year	Applicable Exclusion Amount	Unified Credit	Maximum Tax Rate
2002	$1,000,000	$345,800	50%
2003	$1,000,000	$345,800	49%
2004	$1,500,000	$555,800	48%
2005	$1,500,000	$555,800	47%
2006	$2,000,000	$780,800	46%
2007	$2,000,000	$780,800	45%
2008	$2,000,000	$780,800	45%
2009	$3,500,000	$1,455,800	45%
2010	No estate tax	None	0%
2011	$1,000,000	$345,800	55%

In succeeding years following 2011, the credit would continue to be $1,000,000 and we go back to higher estate tax rates. For the one year period when there is no estate tax, there is carryover basis. EGTRRA eliminates stepped up basis and heirs keep the same tax basis as the decedent and pay capital gains taxes. There is an exclusion for transfers to a spouse and a general exclusion for transfers to other persons.

COMPUTING THE FEDERAL ESTATE TAX

We will now look at several examples which will illustrate how the FET is applied and calculated. First, we need to understand the rate schedule for the FET.

This table applies for persons dying in 2002 or 2003 when the unified credit is $1,000,000. If the taxable estate is, for example, $1,300,000, the estate tax is $124,000. When the unified credit rises to $1,500,000 in 2004, then the tax is zero on $1,500,000 and any amount above that is taxed at the marginal rate applicable.

Federal Estate Tax Table

Taxable Estate	Tax	Rate on Excess
$1,000,000	$0	41%
1,100,000	41,000	41
1,250,000	102,500	43
1,300,000	124,000	43
1,400,000	167,000	43
1,500,000	210,000	45
1,600,000	255,000	45
1,700,000	300,000	45
1,800,000	345,000	45
1,900,000	390,000	45
2,000,000	435,000	49
2,500,000	680,000	50
3,000,000	945,000	50
4,000,000	1,495,000	50
5,000,000	2,045,000	50
6,000,000	2,595,000	50
7,000,000	3,145,000	50
8,000,000	3,695,000	50
9,000,000	4,245,000	50
10,000,000	4,795,000	50
17,184,000	9,105,400	50

This tax table factors in the unified credit of $345,800 on the first $1,00,000 of assets.

The following example illustrates why estates that are less than the unified credit amount after all deductions are taken do not incur any FET.

Example

Phil, a widower, had at the time of his death in 2003 a gross estate for FET purposes of $1,075,000. His estate has deductions for administration expenses and debts in the amount of $75,000. The tax calculation is as follows:

FET Calculation	
Gross estate	$1,075,000
Administration expenses and debts	75,000
Net taxable estate	1,000,000
Tentative estate tax	345,800
Less unified credit	345,800
Net estate tax	**-0-**

This example illustrates how the unified credit effectively eliminates the tax. In fact, a FET return does not even have to be filed where the gross estate is less than the unified credit amount.

The next example illustrates how the unlimited marital deduction also eliminates the estate tax for the estate of the first spouse to die. The second example illustrates the serious tax impact of failing to properly plan for the estate tax consequences that occur on the death of the surviving spouse. Keep in mind that the estate tax in the examples was only deferred until the second spouse's death but not eliminated. There is a better way! In Chapter 12 The A-B Trust Strategy, we will explore how this unfortunate situation can be avoided.

Example

Adam, at the time of his death in 2003, had a gross estate for FET purposes of $1,875,000. His spouse, Michele, survived Adam and was the sole beneficiary of his estate. His estate has deductions for administration expenses and debts in the amount of $62,000.

FET Calculation

Gross estate	$1,875,000
Administration expenses and debts	62,000
Taxable estate before marital deduction	$1,813,000
Marital deduction	1,813,000
Net federal estate tax	**-0-**

The marital deduction is unlimited in amount. This means that a decedent can pass to his surviving spouse any amount of property without causing a FET. As will be seen in Chapter 12 The A-B Trust Strategy where we discuss one of the classic estate planning techniques, leaving everything to the surviving spouse is often not a good tax strategy to follow. This can lead to higher estate taxes on the death of the surviving spouse when all of the assets are accumulated in the surviving spouse's estate. However, the example does illustrate the importance of the marital deduction. The impact of the marital deduction can be further understood by examining what occurs when the surviving spouse in the above example dies.

Example

Michele dies later in 2003. Her estate consists of the following: $1,813,000 that she inherited from Adam the year before, $50,000 which represents appreciation in those assets in the one year interval between their deaths and $512,000 of her own property. Her estate has administration expenses and debts that total $53,000. There is, of course, no marital deduction because Adam has predeceased Michele. Michele's FET is calculated as follows:

Gross estate	$2,375,000
Administration expenses and debts	53,000
Net taxable estate	$2,322,000
Marital deduction	-0-
Taxable estate	$2,322,000
Tentative tax	938,580
Unified credit	345,800
Net federal estate tax	**$592,780**

FILING THE FEDERAL ESTATE TAX RETURN

The FET return is due **nine months** from the date of death, although extensions may be obtained for certain reasons. Additionally, all estate taxes must be paid within nine months from the date of death. Some estates may elect to pay the FET in installments when a material portion of the estate consists of the decedent's interest in a closely held business or farmland.

The **penalties** for failure to timely file the return and pay any tax that is due can be quite severe. The penalty for failing to timely file the return is 5% of the tax due for each month that the return is late up to five months for a maximum penalty of 25%. Failure to pay the tax when due causes a penalty of 5% per month until paid. Interest accrues on each of the penalties along with interest on the unpaid amount of any estate tax due. The United States Estate Tax Return (Form 706) is quite complicated and adequate time must always be left to complete the return and make a timely filing.

CONCLUSION

Once an estate exceeds the unified credit amount in effect for that year, the federal estate tax quickly becomes burdensome because of the high marginal rates. This potential cost is aggravated by the inclusion of virtually all property interests owned by a decedent at death in the taxable estate. There is no better example of this than inclusion of life insurance proceeds paid on policies where the decedent owned the policy.

Lifetime gifts, while helpful in many respects as a tax-planning tool, are not always a complete and satisfactory method of reducing or eliminating the FET. For many persons, it may be extremely difficult, if not impossible, to avoid the payment of all estate taxes at death. However, a good plan always seeks to minimize estate taxes.

Estate planning frequently begins with creating financial models illustrating potential estate taxes and then moves on to an analysis of the available planning techniques that are designed to reduce taxes or provide wealth and liquidity to pay estate taxes. In subsequent chapters, we will discuss some of these strategies. There are many tax planning methods available such as second-to-die life insurance, leveraging lifetime gifts and making charitable bequests. An important role of the estate planning attorney is to bring to the client's attention the planning tools that are available to reduce or minimize estate taxes, or to pay for taxes that cannot be avoided.