

Chapter 3.

The Federal Estate and Gift Tax Process

BACKGROUND

Since 1916, the Federal government has imposed a tax (the estate tax) on the transfer of a decedent's estate, and since 1932, a tax (the gift tax) on the *intervivos* (lifetime) transfer of property by individuals. Over the years, the two taxes have undergone many changes; prior to 1977 they were independent of one another. Since that year, however, the two levies have been companion taxes that must be considered together in the context of estate planning.

UNIFIED RATES

Federal estate and gift tax rates were unified into one rate schedule by the 1976 Tax Reform Act. The rate brackets for both gifts and estates became identical at the time. As shown in table 3.1, the rates in the unified schedule range from a low of 18 to a high of 55 percent on transfers over \$3 million. An additional 5-percent surtax was imposed through 1992 on transfers in excess of \$10,000,000 but not exceeding \$21,040,000. After 1992, the top amount for the 5-percent surtax dropped to \$18,340,000.

UNIFIED CREDIT

The 1976 Act also established a unified estate and gift tax credit to offset taxes owed. The credit has been increased in steps; it reached its current maximum of \$192,800 in 1987. This amount effectively shields \$600,000 (the exemption equivalent) of estate and/or gift assets from Federal taxes. As can be seen by examining the rate schedule in table 3.1, the lowest effective estate/gift tax rate is now 37 percent because of the fully phased in credit.

The use of the credit begins with taxable gifts made during the decedent's lifetime. It is mandatory that the credit be applied to such gifts--no tax is actually paid on a taxable gift until the credit is completely used up. Thus, some or all of the credit may be exhausted during a decedent's lifetime and, therefore, not be available for use by his (her) estate.

Gifts are discussed in greater detail in chapter 8,

including what does and does not constitute a taxable gift. The value of a gift for gift tax purposes is its fair market value on the date of the gift.

DETERMINATION OF GROSS AND TAXABLE ESTATE

Gross Estate

The gross estate is defined as the value of all property, both real and personal and both tangible and intangible, owned by the decedent on the date of death, or in which he (she) had an ownership interest on the date of death. Thus, the first step in the estate settlement process is a complete inventory of the estate assets.

Valuation.--Once property interests have been established, they must be valued. Valuation of both timber and nontimber assets is discussed in detail in the next chapter. The general rule, however, is that property comprising the gross estate must be valued at fair market value either as of the date of death or as of the alternate valuation date. Special use valuation is also possible for timber property and certain other types of estate assets as discussed extensively in chapter 13. Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all of the relevant facts.

The estate assets may be valued as of the date falling 6 months after the decedent's death (alternate valuation date) if two tests are met: (1) alternate valuation decreases the value of the gross estate, and (2) it results in a decrease in the net Federal estate tax payable. The alternate valuation election must be made on the first estate tax return filed and applies to all property in the gross estate. The executor may not alternately value some assets and not others. The return may be filed late without invalidating the election if it is filed no later than 1 year after its due date. The election is also irrevocable--at least after the time for filing has expired.

Table 3.1--*Federal unified estate and gift tax rate schedule*

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Amount on Which Tentative Tax is Computed	Tentative Tax
Not over \$10,000	18% of such amount
Over \$10,000 but not over \$20,000	\$1,800 plus 20% of the excess of such amount over \$10,000
Over \$20,000 but not over \$40,000	\$3,800 plus 22% of the excess of such amount over \$20,000
Over \$40,000 but not over \$60,000	\$8,200 plus 24% of the excess of such amount over \$40,000
Over \$60,000 but not over \$80,000	\$13,000 plus 26% of the excess of such amount over \$60,000
Over \$80,000 but not over \$100,000	\$18,200 plus 28% of the excess of such amount over \$80,000
Over \$100,000 but not over \$150,000	\$23,800 plus 30% of the excess of such amount over \$100,000
Over \$150,000 but not over \$250,000	\$38,800 plus 32% of the excess of such amount over \$150,000
Over \$250,000 but not over \$500,000	\$70,800 plus 34% of the excess of such amount over \$250,000
Over \$500,000 but not over \$750,000	\$155,800 plus 37% of the excess of such amount over \$500,000
Over \$750,000 but not over \$1,000,000	\$248,300 plus 39% of the excess of such amount over \$750,000
Over \$1,000,000 but not over \$1,250,000	\$345,800 plus 41% of the excess of such amount over \$1,000,000
Over \$1,250,000 but not over \$1,500,000	\$448,300 plus 43% of the excess of such amount over \$1,250,000
Over \$1,500,000 but not over \$2,000,000	\$555,800 plus 45% of the excess of such amount over \$1,500,000
Over \$2,000,000 but not over \$2,500,000	\$780,800 plus 49% of the excess of such amount over \$2,000,000
Over \$2,500,000 but not over \$3,000,000	\$1,025,800 plus 53% of the excess over \$2,500,000
Over \$3,000,000	\$1,290,800 plus 55% of the excess over \$3,000,000

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Taxable Estate

The definition of taxable estate is the value of the gross estate less all permitted deductions. These are six in number: funeral expenses, estate administration expenses, debts, casualty and theft losses, the charitable deduction, and the marital deduction.

Funeral Expenses.--These include the costs of interment, the burial lot or vault, grave marker, future care of the grave site, and transportation to bring the body to the burial place. Funeral expenses must be reduced by any reimbursement from the Veterans Administration for funeral expenses and any funeral expense benefit payable to other than the decedent's spouse by the Social Security Administration. The Internal Revenue Service (IRS) takes the position that, if a decedent's estate is not primarily liable for payment of the funeral expenses, no deduction is allowed for Federal estate tax purposes unless the decedent's will directs that the funeral expenses be paid out of the decedent's estate.

Administration Expenses.--These include costs incurred for collection and preservation of estate property, payment of estate debts, and distribution of estate assets. The IRS considers only those administration expenses "actually and necessarily" incurred for such purposes to be deductible.

Debts.--These are personal obligations of the decedent that exist at the time of death, including interest accrued to the date of death. They encompass such obligations as mortgages, liens, unpaid income taxes on income includable on a return of a decedent for the period prior to his (her) death, unpaid gift taxes, unpaid property taxes accrued prior to death, and unpaid medical expenses as of the date of death. Medical expenses incurred by the decedent that are paid within 1 year of death may be deducted either on the estate tax return or on the decedent's final income tax return. Interest expenses accruing after death on debts incurred prior to death generally are not allowed as a deduction. Several courts, however, have not always followed the IRS position on this and have allowed such interest to be deducted if reasonable and necessary for administration of the estate.

Casualty and Theft Losses.--These may be deducted if they occur during estate settlement and prior to distribution of the asset in question to the beneficiary. The deduction is reduced to the extent that the loss is offset by insurance or other com-

ensation and to the extent that it is reflected in alternate valuation if such valuation is elected. A casualty or theft loss may be deducted on either the estate tax return or the estate's income tax return--but not on both.

Charitable Deduction.--A deduction is allowed for estate assets that are transferred by the decedent's will to specified public or charitable entities or uses. These include: the Federal government, a State government, and State political subdivision entities if the transferred assets are used exclusively for public purposes; corporations organized and operated (not necessarily in the United States) exclusively for religious, charitable, scientific, literary, or educational purposes; and veterans organizations incorporated by an act of Congress. There is no limitation on the amount of the charitable deduction, but it cannot exceed the net value of the property that passes to charity as reflected in the gross estate.

Marital Deduction.--The value of certain property interests passing from the decedent to his (her) surviving spouse is permitted to be deducted from the decedent's gross estate. Treasury Regulation 20:2056(e)-2(e) provides that in case of simultaneous death, a presumption (whether by local law, will, or otherwise) that one spouse or the other was the first to die will be recognized.

Determination of Tax Due

The next step is to compute the tentative tax on the sum of the taxable estate plus adjusted taxable gifts. Adjusted taxable gifts are defined as the total amount of taxable gifts made by the decedent after December 31, 1976, other than those gifts includable in the gross estate. Life-time gifts that must be included in the gross estate are discussed in chapter 8. The rate schedule is then applied to this total, resulting in the tentative tax.

Once the tentative tax is determined, it is reduced by the gift taxes (those previously paid plus those not yet paid) on gifts made after December 31, 1976. The result is the gross estate tax. The tax payable on a post-1976 lifetime gift is the amount owed on that gift after the gift tax otherwise payable is reduced by the unified credit. The estate tax reduction for gift taxes paid on such gifts is based on the rate schedule in effect on the date of death, not on the rate schedule in effect at the time of the gift, if the two are different.

Credit Reductions

Once the gross estate tax is determined, it is reduced by certain credits to determine the net tax due. There are five such credits: the unified credit discussed earlier, the State death tax credit, the credit for Federal gift taxes on pre-1977 transfers, the foreign death tax credit, and the credit for Federal estate taxes on prior transfers.

Unified Credit.--The amount of the unified credit available at the decedent's death (\$192,800 minus any credit used for lifetime gifts) will be reduced if the decedent made a taxable gift at any time after September 8, 1976, and before January 1, 1977. Prior to unification of estate and gift taxes in 1977, a specific life-time gift exemption of \$30,000 was permitted. The unified credit must be reduced by 20 percent of the exemption allowed for a gift made during this period. For example, if the decedent had made a gift on October 15, 1976, and used his (her) entire lifetime exemption of \$30,000, the unified credit would be reduced by \$6,000 (20 percent of \$30,000).

State Death Taxes.--A limited credit for State death taxes is allowed (see appendix page 134). It is determined by applying a rate schedule to the value of the taxable estate reduced by \$60,000.

Gift Tax Credit.--This credit is determined by first computing the tax on the cumulative total of lifetime and death taxable transfers. The tax previously paid (or payable) on the lifetime transfers is then deducted.

Estate Tax Credit.--A credit is allowed for the Federal estate tax paid on transfers to the decedent of property from a transferor who died within 10 years before or 2 years after the decedent's death. The credit is the smaller of: (1) the amount of the Federal estate tax attributable to the transferred property in the prior decedent's estate or (2) the amount of the Federal estate tax attributable to the transferred property in the present decedent's estate. If the transferor dies within 2 years before or 2 years after the decedent's death, full credit is allowed. If the transferor dies more than 2 years before the decedent, the credit is reduced by 2 percent for each 2-year period.

Foreign Death Tax Credit.--A credit is allowed for foreign death taxes paid with respect to property in the decedent's estate if the property is actually situated in a foreign country. The credit is the lesser of the foreign death tax or the Federal estate tax attributable to the property.

Estate Tax Computation

Example 3.1. Assume that the decedent died in 1988 with a gross estate valued at \$607,800. In 1979, the decedent had made a lifetime gift of property valued at \$253,000 to his daughter. He had filed a gift tax return and paid a net gift tax of \$34,800 (tentative gift tax of \$70,800 minus the unified credit available at that time of \$38,000). There were no other lifetime gifts.

The decedent's gross estate includes the gift taxes paid but not the value of the gift. The taxable portion of the gift, however, is added to the taxable estate to determine the tentative tax, as discussed above, because the gift is not included in the gross estate. The net estate tax is computed as follows:

Gross estate	\$607,800
Minus debts and administrative expenses	<u>(107,800)</u>
Taxable estate	500,000
Add adjusted taxable gifts (\$253,000 minus the \$3,000 annual exclusion that prevailed in 1979)	<u>250,000</u>
Taxable amount	750,000
Tentative tax	248,300
Minus gift tax paid (or payable)	(34,800)
Gross estate tax	213,500
Minus unified credit	<u>(192,800)</u>
Subtotal	20,700
Minus State death tax credit	<u>(10,000)</u>
Net estate tax due	\$ 10,700