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THINK ABOUT IT

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TODAY'S ESTATE TAX SYSTEM IN A NUTSHELL

There has been an ongoing push for total repeal by the Republicans and counter-effort by the Democrats for modification of the federal estate tax law since the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA 2001). On April 13, 2005, the U.S. House of Representatives voted (272-172) to "fully, permanently, and immediately" repeal the federal estate tax. The House turned down (238 to 194) a Democratic attempt to compromise that would have allowed couples an exemption of $7,000,000 and individuals $3,500,000. The House has passed such bills before. The issue will be addressed by the Senate in May or June.

This report gives you my personal (and admittedly biased) opinion on repeal (feel free to share it with others) and contains a simplified explanation of the major provisions of the federal estate tax law as it exists currently. A more detailed discussion of the estate tax valuation and tax computation process can be found in Tools and Techniques of Estate Planning. Following my personal comments on (and concerns about) estate tax repeal, I will examine the major components of today's federal estate tax: (1) the gross estate, (2) deductions from the gross estate, and (3) how the tax is computed as well as what credits are still allowable to reduce the tax liability.

I'D VOTE FOR REPEAL IF . . .

Estate tax repeal is nothing more than masterful marketing of a cruel hoax aimed at the general public. Estate tax repeal is one of those grand "something for nothing" schemes that everyone wants but no one is willing to pay for. The insinuation of those calling for total and immediate estate tax repeal is that it would simply make a tax go away. Like matter, taxes (especially in a time of massive deficits and growing cash needs the scale of which our federal and state governments have never before faced) are indestructible; instead, they undergo formation and/or alternation and reappear. And that's exactly what will happen with repeal of the federal estate tax. It will merely shift the tax bill to those less (if not least) able to afford it, and be called by a different name. The ultra rich will call it repeal but when the truth dawns on the powerless pawns, it will be called democratization (or sharing of the tax burden) – everyone will get a chance to pay it!

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No one wants to pay taxes. So, I personally would be happy to vote for estate tax repeal:

- if our government ran steady surpluses – instead of the largest budget deficits in the history of the world (that keep spiraling upward with no end in sight);

- if repeal wouldn't drain almost $750 BILLION away from Social Security, Medicaid, education, and veterans' benefits – in just the next 10 years;

- if it wouldn't shift the tax burden from some of the wealthiest people in the world to everyone else (read: middle class folks who are wondering, for example, how they are going to send their children to college);

- if this were honestly about REAL farmers losing the family homestead, and closely-held business owners the family businesses;

  (I'm sure there are a few situations where farmers or ranchers lost their farm or land that had been in the family for generations. But did those same people tell their insurance agents they didn't need any life insurance for estate liquidity, and their lawyers they didn't need any estate planning? Likewise, most closely-held businesses fail to plan for continuity or survival because of (1) family relationship issues, and/or (2) lack of competency and preparedness of the successor generation.)

- if the public were told – without the gimmicks of sunset provisions and obfuscation of a complex, perpetually burdensome carryover basis system – the truth; that is: WHAT repeal will REALLY cost, WHO will REALLY pay for it, and WHEN the payments will REALLY be due!

- if we had a clue when the unbelievable cash drain from our continuing wars in Afghanistan and Iraq would end;

- if I thought that someone could tell me how my children and grandchildren – as well as yours and your clients' – would be expected to pay off the debts our federal government has been running up;

- if, given the economic environment, doing away with this tax at this time would be a luxury we could afford either now or in the foreseeable future. Can you spell F I S C A L R E S P O N S I B I L I T Y? Can Congress?

- if I didn't truly believe that those who are the most financially fortunate people on earth, their heirs (and in some cases "heirheads"), or others who didn't earn the money or amass the wealth in question, didn't have some responsibility to "give back" to our great country – and to generations that follow;

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- if someone could tell me why a modification of the present estate tax exemption and perhaps a tweaking of the rates wouldn't be the logical and appropriate (read: fiscally responsible) alternative to total repeal under our country's current financial condition;

Setting exemption levels at $3.5 or $4 million per person translates to a meaningful amount of exemption per couple! It's more than fair and equitable. Additionally, through the annual gift tax exclusion, judicious and prudent use of life insurance as well as various types of trusts, and other relatively simple and certain planning tools and techniques available under current tax law, even those with estates well in excess of 10 or 15 million dollars could shift incredible amounts of wealth to, and assure much, much more than adequate financial security for, future generations.

There may come a time when I would be happy to vote for repeal . . .

But it's **NOT NOW**!

FEDERAL ESTATE TAX OVERVIEW

No matter what happens in Congress in the coming weeks or months, the likelihood that the federal estate tax will be repealed immediately (i.e. for individuals dying in the next few years) is very small. For that reason, an understanding of the current system remains an important aspect of the services you provide. For purposes of this report, discussions of the estate tax system assume that the decedent/estate owner and his/her spouse, if living, are U.S. citizens.

There are five stages in computing the federal estate tax. The starting place is the "gross estate." This is comprised of all properties in which the decedent has an interest and the total value of which is required to be included in his/her estate. Second, certain allowable deductions are available to reduce the gross estate to an "adjusted gross estate."

Primarily, the adjusted gross estate is used to determine whether or not the estate meets the requirements for IRC Section 303 (stock redemption), and/or Section 6166 (installment payment) treatment. Further deductions reduce the gross estate in the third stage of the process to the "taxable estate." It is determined by subtracting from the adjusted gross estate any allowable marital and/or charitable deduction(s). The fourth stage is computing the federal estate tax payable before credits, which is called the "tentative tax." It is derived by adding to the taxable estate the total of post-1976 lifetime taxable gifts made by the decedent (that have not already been included in the gross estate for some reason). At this point, tax rates are applied. In the fifth and final stage, the tentative tax is reduced, dollar for dollar, by certain allowable estate tax credits and the result is the amount of estate tax owed by the decedent's estate.

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Briefly, the five steps are:

1. Compute the gross estate.
2. Compute the adjusted gross estate.
3. Compute the taxable estate.
4. Compute the federal estate tax payable before credits.
5. Compute the federal estate tax payable after credits.

EGTRRA 2001 generally repeals federal estate taxes for one year at the end of the year 2009. Between 2005 and 2009, the maximum estate tax rate will gradually be lowered, and the applicable exclusion amount will increase periodically – with the largest increase scheduled for 2009.

(NOTE: During the year of estate tax repeal, a modified carryover basis regime would apply for income tax purposes for property received from a decedent. Although a more detailed discussion of this aspect of EGTRRA is beyond the scope of this commentary, it should be noted that the basis of the person acquiring property from a decedent dying in 2010 will generally be equal to the lesser of (1) the adjusted basis of the decedent, or (2) the fair market value of the property at the date of the decedent's death. However, step-up in basis is retained for up to $1,300,000 of property acquired from a decedent; and in the case of certain transfers to a spouse, an additional $3 million will be available – for a total of $4.3 million.). Everyone would have to keep records of the cost of all appreciable assets – forever!

ASCERTAINING THE GROSS ESTATE

The federal estate tax is a levy on the transfer of property at death. A decedent's gross estate includes both property actually owned by the decedent when he/she dies (such as cash, stocks, bonds, real estate, jewelry, and other items) as well as certain interests in property which the decedent had transferred during lifetime to another person. It includes the value of all property, real or personal, tangible or intangible, no matter where it is located, in which the deceased owned an interest the day he/she died.

Each asset is individually valued, generally at its fair market value (FMV) on the date of death. "Fair market value" is defined as the price for an asset which a hypothetical willing buyer would pay and a hypothetical willing seller would sell, assuming both parties had reasonable knowledge of the relevant facts and neither party was under compulsion to buy or sell.

With one important exception, property must be assessed at its "highest and best use" rather than the current or some lower use value. The exception applies in a special rule under which real estate used in certain closely-held businesses and family farms will, under certain conditions, be valued for estate tax purposes at its "special use" value.

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The decedent's executor may also elect to use an alternative to date-of-death valuation. This so-called alternate valuation date is the earlier of (a) the date of distribution or disposition of the property by the estate, or (b) the date six months after the date of death.

Certain types of property (or an interest in property) are included in a decedent's gross estate under special rules (of IRC Sections 2033-2042, for instance). They are includable even if the decedent had given away the property during his/her lifetime and, in certain instances, no matter how many years have elapsed between the date of the gift/transfer and the date of the donor's death. The most common types of property include:

EXAMPLE: Life insurance proceeds payable on the insured-decedent's death are includable in the decedent's gross estate if either (a) the proceeds are payable to or for the use of his/her estate, or (b) the insured-decedent held any "incidents of ownership" in the policy on the date of death, or had given away within three years of that date. The term "incidents of ownership" is broadly defined to include an economic interest such as the right to cancel the policy, change the beneficiary, or borrow against its cash surrender value.

EXAMPLE: The value of an annuity purchased by the decedent or on his/her behalf by an employer (e.g. through a pension plan) during lifetime but payable beyond the annuitant-purchaser's death (i.e. a survivor annuity), or payable because of the decedent's death, will be included in the decedent's gross estate if the deceased had the right to receive a lifetime annuity under the same contract.

EXAMPLE: Property owned by a decedent jointly with a right of survivorship in another person (other than the decedent's spouse) is fully included in the decedent's gross estate, except to the extent the survivor can prove he/she (or someone other than the decedent) contributed money or money's worth of consideration towards the cost of acquiring the property.

EXAMPLE: One-half of the value of property owned jointly with a right of survivorship by a decedent and his/her surviving spouse will be included in the decedent's gross estate, regardless of the relative contributions of the decedent and the surviving spouse.

EXAMPLE: An executor must include in a decedent's gross estate the value of lifetime gifts over which the decedent retained a life interest or a power to alter, amend, terminate, or destroy the beneficial enjoyment of the property (e.g., if a client sets up a revocable living trust and transfers property into the trust). Gifts/transfers "made" during lifetime but the donor did not pass control or enjoyment of the property/principal and/or its income to the donee until death are also considered "testamentary" transfers, and therefore included in the gross estate of the decedent-donor.

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NOTE: The value of property sold during the decedent's lifetime is not included in the decedent's estate under the above provisions – IF it is sold for full and adequate consideration in money or money's worth. Additionally, the following are included in the decedent's gross estate:

Transfers within Three Years of Death

Generally, property given away within three years of death will NOT be brought back into the transferor's gross estate. However, a decedent's estate WILL include the value of interests in property given away within three years of the date of death if, had the property been retained, it would have been included in the decedent's gross estate under (a) certain special rules noted above, or (b) the property consisted of life insurance on the decedent-transferor's own life.

NOTE: Transfer of a policy by the insured/owner, even if within three years of his or her death, is not includible for estate tax purposes, if it is for full and adequate consideration in money or money's worth. However, be aware that the sale of a policy is a transfer for valuable consideration and the proceeds are income taxable to the beneficiary(ies) under the "transfer for value" rule – unless the transferee is an "exempt" party such as a partner of the insured, or a partnership in which the insured is a partner (regardless of the identity of the transferor).

Powers of Appointment

A power of appointment is defined as a right, held by a person (other than the owner of property), to determine who will enjoy the ownership rights or beneficial interests, of the property.

A power of appointment is "general" if it may be exercised by its holder in favor of the holder, the holder's estate, the holder's creditors, or the creditors of the holder's estate. Therefore, a decedent's estate also includes the value of all property subject to a general power of appointment held by the decedent on the date of death – even if the decedent died without exercising the power and even if it was physically impossible for the decedent to have done so.

Conversely, a power is "special" or "limited" if it cannot be exercised in favor of the holder, the holder's estate, the holder's creditors, or the creditors of the holder's estate. As a result, a special or limited power of appointment does NOT cause inclusion of the property that may be transferred by the holder in his/her gross estate.

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ALLOWABLE DEDUCTIONS, THE ADJUSTED GROSS ESTATE, AND TAXABLE ESTATE

Certain estate administration costs, expenses, debts and losses may reduce a decedent's gross estate in arriving at what is known as the adjusted gross estate. Further deductions reduce the adjusted gross estate to the taxable estate. These adjustments include:

1. estate administration expenses,
2. certain debts and losses,
3. the amount of qualified transfers to the surviving spouse,
4. charitable bequests, and
5. state death taxes.

Estate Administration Expenses, Debts and Losses

To determine the adjusted gross estate, a decedent's estate is allowed a deduction for funeral expenses, administration expenses, claims against the estate (including property and unpaid income and other taxes), and unpaid mortgages paid by the estate (to the extent not reflected in the reduced value of estate assets) from the value of the gross estate.

These payments may be deducted to the extent that they are actually paid by the estate, and to the extent they are allowable under applicable state law.

An estate may also take a deduction for casualty or theft losses sustained by the estate during settlement – if and to the extent such losses are not compensated by insurance, or otherwise.

The Marital Deduction

Of all the possible deductions, the most important (read: LARGEST) allowed in the case of married individuals is the marital deduction. This deduction applies to the value (unlimited under current law) of all property passing to the decedent's U.S. citizen spouse in a manner which qualifies for the marital deduction.

With certain statutory exceptions, the federal estate tax marital deduction is allowed only for property which passes outright or in a manner tantamount to outright. A person's estate can obtain a marital deduction for interests that pass from the decedent to his/her U.S. citizen spouse:

1. by will,
2. through intestacy law,
3. by contract,
4. by operation of law, or
5. otherwise.

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Interests in property which do NOT qualify for a marital deduction include so-called "terminable interests." For instance, interests that, although they may go to the surviving spouse, might also "terminate" (such that the spouse does not actually become the sole and absolute owner) and if they do, pass to some person other than the surviving spouse or his/her estate because of the mere lapse of time, the occurrence of an event or contingency, or the failure of an event or contingency to occur.

Special exceptions to the terminable interest rule are made for certain interests conditioned upon survivorship for a reasonable period not exceeding six months, and certain transfers in trust if:

1. The surviving spouse receives a lifetime income, and
2. The executor makes an election to include the value of the trust property in the surviving spouse's gross estate, or
3. The surviving spouse is given a general power of appointment over the property in the trust, or
4. It is in the form of certain life insurance settlement options.

Charitable Deduction

In arriving at the taxable estate, an executor can also take a deduction from the adjusted gross estate the value of certain charitable bequests and devices to qualified charitable organizations. Generally, if an income tax deduction would have been allowed for a given gift, an estate tax deduction will be permitted. The charitable deduction is unlimited and it is conceivable that, in the event the entire estate (regardless of its value) was left to a qualified charity, the estate would be allowed a deduction large enough to offset any federal estate tax liability.

State Death Tax Deduction

Most states impose a death tax of some type. Some state death taxes can be significant. For federal estate tax purposes, a deduction is allowed for the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia in respect to property included in the gross estate of a decedent. (As amended by EGTRRA 2001.)

COMPUTING TAX LIABILITY

Currently, we have what is called a "unified" estate, gift, and generation-skipping transfer tax system. That system requires that the taxable portion of any lifetime gifts made after 1976 be added to a decedent's "taxable estate." The effect of this so-called gross-up is to increase the rate at which the taxable estate is taxed. Once the addition of those lifetime gifts is made to transfers at death, the tax rate is applied to calculate the "tentative tax." Lastly, the tentative tax is reduced by the decedent's available estate tax credits on a dollar-for-dollar basis, and the result is the actual federal estate tax liability due and payable.

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ESTATE TAX CREDITS

Under current federal tax law, there are three major estate tax credits:

1. The "unified transfer tax credit,"
2. The credit for foreign death taxes, and
3. The credit for federal estates taxes paid by estate of previously deceased transferor.

As I have noted above, each credit results in a dollar-for-dollar reduction of the estate's otherwise payable federal estate tax.

The Unified Credit

A person can apply the unified tax credit against gifts made during lifetime or gifts made at death – or to both. This means it is available to reduce and, in most cases, eliminate a person's gift and estate tax liabilities. Aside from the estate tax marital deduction, the unified credit is the single most potent estate (and gift) tax-savings tool.

Of course, if a person uses up all or a portion of the unified credit while he/she is alive, it will not regenerate at death. Stated simply, to the extent a person exhausts his/her unified credit while he/she is alive (usually a smart move), it will not be available at death.
Technically, we refer to the amount of taxable estate (or gift) that the credit offsets as an "applicable exclusion amount" (also called "exclusion equivalent").

For this year (and 2004) the credit covers taxable transfers up to $1,500,000. Between 2006 and 2009, it will increase in the following manner:

Year of Transfer	Applicable Exclusion Amount
2005	$1,500,000
2006-2008	2,000,000
2009	3,500,000

Credit for Foreign Death Taxes

Each estate is also allowed a credit for foreign death taxes (e.g., estate, inheritance, legacy, or succession) actually paid by the estate (or any heir) to a foreign country with respect to property included in the federal gross estate.

This credit is limited to the amount of U.S. estate taxes paid on the same property.

The credit is computed multiplying the total U.S. estate tax by this fraction:

Value of the foreign taxed property/Total of the U.S. taxable estate.

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Credit for Previously Tax Property

A Previously Tax Property (PTP) credit is allowed to alleviate some of the unfairness of "double taxation" that might otherwise result if an individual dies soon after inheriting property from another decedent (transferor) upon which a federal estate tax has already (and recently) been imposed.

Depending on the time between the two deaths, the PTP credit is allowed for all or some portion of the federal estate taxes paid on property transferred to the present decedent – if the transferor died within ten years before or two years after the present decedent. (No credit is allowed if the transferee predeceases the transferor by more than two years.)
The credit is graduated, and the less time that has elapsed between the two deaths, the greater the credit.

The maximum PTP credit is 100% of the previously paid taxes. This maximum percentage applies if the transferor dies within two years before or after the present decedent. Assuming the transferor dies more than two years before the decedent (but within 10 years), the PTP will be reduced as follows:

Percentage	Yr. of Transferor's Death before Decedent's Death
80%	If within 3rd or 4th years
60%	If within 5th or 6th years
40%	If within 7th or 8th years
20%	If within 9th or 10th years

PAYMENT OF THE FEDERAL ESTATE TAX

The federal estate tax is due (absent a reasonable cause extension) at the same time the return is filed. That date is nine months after the estate owner's death. A return must be filed if the gross estate is greater than the "applicable exclusion amount" (also called the "exemption equivalent") sheltered by the estate tax unified credit. That is, if the gross estate is greater than: $1,500,000 in 2005, $2,000,000 in 2006, 2007, and 2008, and $3,500,000 in 2009.

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