



Business assets held until death may be eligible for the family-owned business deduction for federal estate tax purposes. Thus, part or all of the business assets may be deducted from the gross estate. Excess cash or non-business investments from a sale of business assets before death would not be eligible for the deduction. The family-owned business deduction is discussed below.

### **The gross estate**

The gross estate includes land, inventory items, machinery, bank accounts—all the real and personal property of the decedent.

The gross estate also includes the decedent's proportionate ownership of property held in tenancy in common. That's usually half. However, it could be any fractional share if it is clearly spelled out on the title that the decedent owned a portion other than half. Otherwise it is presumed that half the value would be included in the gross estate for two person tenancies in common.

### **Joint tenancy property**

When a person dies owning property in joint tenancy, one of two rules is applied to determine the portion of value subject to federal estate tax. Under the "consideration furnished" rule, applicable to all joint tenancies except those involving only husbands and wives, the full value of the property is included in the estate of the first person to die for federal estate tax purposes (and the full value receives a new income tax basis), except to the extent the survivor can prove he or she provided the money when the property was acquired or the mortgage paid off.

A 1992 case and five later cases have allowed an estate to apply the consideration furnished rule at the death of the first of a couple to die survived by the other spouse. The outcome can be highly beneficial to the estate where land was purchased after 1954 and before 1982 with the first spouse to die providing a disproportionate part of the purchase price. If the first to die provided all of the funding on acquisition, the property (farmland) was fully includible in the estate of the first to die, the full amount was

deductible under the federal estate tax marital deduction and the entire amount of gain was eliminated for income tax purposes. The latter point is especially important where the property is sold after the first death.

The "fractional interest" rule makes one-half the value of joint tenancy property held by a husband and wife subject to federal estate tax. Each is considered to own half the property for federal estate tax purposes.

A major problem with joint tenancy is that it can create a heavy tax burden at the survivor's death. Since property is transferred outright to the survivor, the entire value of the property is included frequently in the estate of the survivor. For those concerned with federal estate taxes, the best strategy, therefore, might be to get out of joint tenancy.

### **Certain transfers during life**

Property transferred by gift within three years of death is not included in the estate at death for federal estate tax purposes. There are, however, two categories of exceptions to that general rule:

- transfers of property are included in the decedent's gross estate if the decedent retained a life estate in the property, the transfer was to take effect at death, the transfer involved a revocable transfer, or the transfer involved a life insurance policy; and
- for purposes of determining eligibility for special use valuation of land, installment payment of federal estate tax and redemptions of corporate stock to pay death taxes and estate settlement costs, property transfers by gift within three years of death are included in the gross estate for the limited purpose of determining whether the eligibility requirements have been met.

Because life insurance policies fall within the exception, a transfer of insurance policies by gift within three years of death makes the proceeds (or the value of the policy if on another's life) includible in the insured's gross estate.

Under a different rule, retaining control over property that is transferred may also make the property subject to tax. The general rule is that to give away property to save taxes at death, all connections must be severed with the property. For example, a couple cannot save taxes by deeding a farm to the children while retaining the right to collect the income.

Thus, the gross estate contains all property owned outright by the individual, property transferred with retained powers, and some property given within three years prior to death.

### **Insurance proceeds**

Proceeds of life insurance policies may be subject to the federal estate tax, depending on the circumstances. Two factors determine whether proceeds are taxable: policy ownership and beneficiary designation. If the person who dies and whose life was insured is also the owner of the policy, the proceeds are subject to the federal estate tax.

If the beneficiary is the estate of the insured, the insurance proceeds are subject to tax. Thus, two conditions must be met for insurance proceeds not to be taxed. First, the owner of the policy must be someone other than the insured, and second, the beneficiary must be someone other than the insured's estate.

### **Retirement benefits**

In general, the value of a retirement plan is included in an estate. If you are involved in a qualified employee plan or retirement plan, your plan administrator can indicate the amount that would be included in the gross estate.

### **Deductions**

In computing the federal estate tax, the first step after determining the amount of the gross estate is to identify deductions. Deductible items include debts of the decedent, the attorney's fee, the executor's fee, court costs, and costs of last illness, death, and burial. The costs involved in selling property, if claimed as a federal estate tax deduction, cannot also be used to offset gain for income tax purposes.

### **Marital deduction**

A marital deduction may be claimed for property passing to a surviving spouse. Since the marital deduction is 100 percent of the qualifying property passing to a surviving spouse, the marital deduction is a major factor in planning for estate tax saving.

### **Charitable deduction**

There is also a 100 percent federal estate tax charitable deduction. To qualify for that deduction, the gift must be made to a qualified charity. A qualified charity is a church, a division of government, or an organization that has been approved by the IRS as authorized to give a charitable deduction.

### **Calculating the estate tax**

Estate and gift taxes were unified into a single system in 1976, and remained unified through 2003. Under this unified system, gift taxes were calculated based on accumulated taxable gifts made by an individual during life. Estate taxes were calculated on the decedent's taxable estate at death, reduced by gift taxes paid on post-1976 taxable gifts (except for gift taxes paid within three years of death). To the extent the decedent did not use the available lifetime gift exemption against taxable gifts during life, the balance was available to be utilized against the estate tax at death.

A decedent's taxable estate is determined by subtracting from the decedent's gross estate (adjusted for gifts and gift tax within three years of death except for amounts covered by the federal gift tax annual exclusion), costs of estate administration, allowable losses, the marital deduction, and charitable deduction. Taxable gifts after 1976 and before 2004 (those not covered by the federal gift tax annual exclusion, marital deduction or charitable deduction) are included in the taxable estate for purposes of determining the amount of prior use of the unified credit (now known as the applicable credit amount) and the point to begin figuring federal estate tax on the graduated tax schedule.

Once all items are included in the calculation of the gross estate and all appropriate deductions are taken, the federal estate tax is computed. The tax is graduated, beginning at 18 percent and ending at 55 percent for deaths occurring and gifts made after 1983 and before 2002, and after 2010. Table 1 sets forth the present federal estate and gift tax rate schedule.

Legislation enacted in 2001 drops the top estate and gift tax rate to 50 percent in 2002, 49 percent in 2003, 48 percent in 2004, 47 percent in 2005, 46 percent in 2006 and 45 percent for years 2007 through 2009. Thus, for 2007, the maximum gift and estate tax rate is 45 percent on taxable amounts over \$2,000,000. The maximum gift tax rate falls at the same rate as the federal estate tax, but is set at the maximum individual rate of 35 percent of the excess over \$1,000,000 for gifts made in 2010. Estate tax is slated for repeal for deaths in 2010.

Beginning in 2004, the estate and gift tax systems are decoupled. The gift tax exemption remains fixed at \$1,000,000, but the estate tax exemption is \$2,000,000 for deaths in 2006 through 2008. The estate tax applicable exclusion amount increases through 2009. The estate tax is repealed in 2010, but returns in 2011 with an applicable exclusion of \$1,000,000. The following table sets forth the scheduled increase in the estate tax applicable exclusion, as well as the gift tax applicable exclusion and a comparison of the top tax rates applicable to estate and gifts.

After the federal estate tax is computed, certain credits may be subtracted. These include a portion of any state death taxes paid, part or all of federal estate tax paid if the property had passed through an estate in the previous ten years, and death taxes paid to a foreign government. As noted in Table 2, the applicable exclusion amount exempts (for 2006-2008) the first \$2 million of estate value from estate tax by virtue of a credit against the estate tax of \$780,800. The applicable exclusion gradually increases through 2009.

**Table 1. Estate and gift tax table (transfers after 1983 and before 2002; and after 2010).**

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

**Table 2. Estate and gift tax applicable credit amounts and top tax rates**

Year	Estate Tax Applicable Exclusion Exemption Amount	Estate Tax Applicable Credit Amount	Estate Tax Top Rate	Gift Tax Lifetime Exemption	Gift Tax Applicable Credit Amount	Gift Tax Top Rate
2002	1,000,000	345,800	50%	1,000,000	345,800	50%
2003	1,000,000	345,800	49%	1,000,000	345,800	49%
2004	1,500,000	555,800	48%	1,000,000	345,800	48%
2005	1,500,000	555,800	47%	1,000,000	345,800	47%
2006	2,000,000	780,800	46%	1,000,000	345,800	46%
2007	2,000,000	780,800	45%	1,000,000	345,800	45%
2008	2,000,000	780,800	45%	1,000,000	345,800	45%
2009	3,500,000	1,455,800	45%	1,000,000	345,800	45%
2010	Repealed	Repealed	Repealed	1,000,000	345,800	35%
2011	1,000,000	345,800	55%	1,000,000	345,800	55%