

Note: This article is a basic overview of concepts related to the federal estate tax and is intended to give individuals points to consider as they engage in the estate planning process. Do not consider this article to be exhaustive as the possible impact of federal estate tax is quite complex and will vary with each individual situation. This article is considered educational in nature and should not be considered legal advice. Consult with qualified legal and tax professionals who can provide expert advice on specific needs. Also consult with federal websites and publications that contain the most up-to-date information on federal estate tax law.

Property owned by a person at the time of death is known as the decedent's estate. When the estate is transferred to the recipients (known as heirs), the federal government may impose a tax on the right to transfer that property. That is the federal estate tax. The tax is owed by the estate of the decedent and is paid by the estate prior to the transfer of the remaining property. Heirs who receive money or property from an estate do not pay the estate tax, nor do they pay any income tax on the value of the inherited property.

What estates are subject to a federal estate tax?

The amount of the estate tax is based upon the value of the estate at the time of death. Federal law allows a certain amount of property to be transferred at death without any tax obligation. The amount that can be transferred to others without tax is known as the "unified credit." This amount has changed over time. By way of review, the basic exclusion amount was \$1,500,000 in years 2004-2005; \$2,000,000 for years 2006-2008; \$3,500,000 in 2009; and \$5,000,000 in years 2010-2011. In 2012, the exclusion amount was increased by inflation indexing to \$5,120,000. In January 2013, Congress passed and the president signed the American Taxpayer Relief Act (ATRA) of 2012 which made the \$5 million exemption amount permanent – that is, without an expiration date contained in the legislation, which brought an increased level of certainty for professional planners and those who have estates that could be impacted by federal estate or gift taxes. The exemption under ATRA increased each year with

inflation indexing as noted here in these amounts: \$5,250,000 (2013), \$5,340,000 (2014), \$5,430,000 (2015), \$5,450,000 (2016), \$5,490,000 (2017). It was predicted to be up to \$7.5 million by 2020 and this was the law for deaths through the end of 2017. For more information, see IRS Publication 559 (Survivors, Executors or Administrators), www.irs.gov/pub/irs-pdf/p559.pdf.

In December 2017, the Congress passed and the president signed the Tax Cuts and Jobs Act (TCJA) of 2017. The provisions of this law were effective on January 1, 2018. The TCJA increased the exemption amount from \$5 million to \$10 million – indexed for inflation from 2010. This increase in the TCJA is effective until January 1, 2026 when the amount will revert to 2017 levels (an expiration or "sunset" provision) unless the law is extended or modified. In early 2018, the IRS announced that the 2018 exemption amount is \$11.18 million (or \$22.36 million for a married couple). Again, the exemption will be adjusted for inflation in subsequent years.

How many estates are subject to federal estate tax?

Data on how many estates actually pay federal estate tax is gathered by the Tax Policy Center (TPC), a non-partisan joint venture of the Urban Institute and the Brookings Institution, www.taxpolicycenter.org. For 2017 deaths, when the exemption was \$5.49 million, the Tax Policy Center estimated there would be about 5,500 taxable estates with total estate tax liability of around \$19.9 billion. Putting this in perspective, the TPC pointed out that of the approximately 2.7 million deaths in 2017, only 1 in 487 deaths would

pay any estate tax. For 2018, the TPC estimates that the number of estates subject to federal estate tax will fall to about 1,700 which is equal to less than 0.1 percent (1/10th of 1 percent) of all deaths; and the amount of estate tax owed will be reduced to \$13.6 billion. For 2017 deaths, the TPC estimated that perhaps 80 small farms and closely held businesses would pay any estate tax, www.taxpolicycenter.org/briefing-book/who-pays-estate-tax. With the increased exemption amount for 2018, that number will decrease significantly.

How is property valued for purposes of federal estate tax calculations?

Property included in the gross estate is valued at its fair market value (FMV) as of the decedent's date of death. For certain types of property, a qualified appraisal may be necessary to determine the appropriate value. In unusual cases, an alternate valuation date within six months after death may be used – typically done if property values have declined after the date of death.

Under certain conditions, land used in farming or other closely held (family) business may be valued at what is called a **special use value**, which may be lower than FMV. The idea behind allowing a use value is to provide an additional tax break for family farming operations intended to be transferred from one generation to the next. Use value is based on dividing the five-year average local cash rental rate by a federal land bank interest rate. To elect use value, the land must have been used as a farm for five years during the eight-year period ending with the decedent's death, and the decedent or a member of the decedent's family must have **materially participated** in the farm business. The key factors in determining whether there was material participation are physical work and participation in management decisions. Generally, to constitute material participation, the decedent or a member of the decedent's family must have been a full-time employee of the farm operation. The land must pass to a qualified heir,

generally the spouse or a lineal descendant or ascendant. If the property is sold to a nonfamily member or ceases to be used for farming within 10 years following the death, all or a portion of the federal estate tax benefits obtained under a special use valuation provision must be repaid. Competent legal or tax professionals should be consulted to learn more about property valuation and the requirements to elect use value on family farm land.

How is the federal estate tax calculated?

The executor of an estate must file a federal estate tax return within nine months of a person's death if that person's gross estate exceeds the exempt amount (\$11.18 million in 2018, with this amount continued to be indexed for inflation). The estate tax is applied to the decedent's gross estate, which generally includes all of the decedent's assets, both financial (such as stocks, bonds, and mutual funds) and real (homes, land, and other tangible property). It also includes their share of jointly owned assets and life insurance proceeds from policies owned by the decedent. After the gross estate is valued, deductions are subtracted to arrive at the net taxable estate. Federal estate tax law allows an unlimited deduction for transfers to a surviving spouse and to charity. Other deductions are allowed for debts, funeral expenses, legal and administrative fees, and state inheritance taxes paid. Therefore, the gross estate less the allowable deductions equals the net taxable estate. Once the amount of the net taxable estate is determined, the applicable credit exempts a large portion of the estate – again, \$11.18 million for 2018 deaths. Any remaining value of the estate over that amount faces a tax rate of 40 percent. See generally IRS Instructions for Form 706, www.irs.gov/pub/irs-pdf/i706.pdf.

In summary, the steps in calculating the Federal Estate Tax are:

1. Determine the value of the gross estate.
 2. Subtract allowable deductions.
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3. Add the value of taxable gifts made after 1976 if not already included in the gross estate. (Remember that the estate and gift tax rate is based on cumulative transfers. The gift tax paid on taxable gifts made after 1976 is subtracted in Step 5.)
4. Consult tax tables for the unified rate schedule for the applicable rate of tax and apply the unified estate and gift tax rates.
5. Subtract the amount of gift taxes paid on taxable gifts made after 1976.
6. Subtract the allowable unified credit and any other allowable credits. The resulting amount is the net federal estate tax owed by the estate.

When must the federal estate tax return be filed and the tax paid?

If the value of a decedent's gross estate is large enough to trigger the filing of a Federal Estate Tax return, IRS Form 706-Estate Tax Return is due nine months after the date of death. Extensions of various lengths, available to file the return or to pay the tax, are available if good cause can be shown. Interest accrues on estate tax payable. Penalties may be assessed against the estate if the federal estate tax is not paid when due and extensions are not obtained. Extensions available

include a one-year extension based on good cause shown; or a five-year deferral or ten-year installment payments for closely held businesses where the decedent's interest in the closely held business exceeds 35 percent of the decedent's gross estate. Requirements necessary to obtain such extensions or allowance for installment payments are contained in the law and available from a qualified legal representative. Penalties may be imposed for undervaluing the estate property or for fraud. In the most extreme cases, criminal penalties, fines, or imprisonment may be imposed.

Additional Resources

AgDM Transition & Estate Planning materials, www.extension.iastate.edu/agdm/wdbusiness.html

Center for Ag Law and Taxation, www.calt.iastate.edu/article/highlights-tax-cuts-and-jobs-act-agricultural-producers

IRS Forms and Publications -- Estate and Gift Tax, www.irs.gov/businesses/small-businesses-self-employed/forms-and-publications-estate-and-gift-tax

Tax Policy Center, www.taxpolicycenter.org

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