Evaluating Your Estate Plan: Federal Estate Taxes

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 and is subject to future change. For persons dying in 2011, federal law allowed a decedent to transfer up to $5 million of property to others without tax. In 2012, that amount was increased by inflation indexing to $5,120,000. In January 2013, Congress passed and the president signed the American Taxpayer Relief Act of 2012. This act made a number of key provisions related to federal estate and gift taxes permanent – that is, without an expiration date contained in the legislation. This brings an increased level of certainty for professional planners and those who have estates that could be impacted by federal estate or gift taxes. Under the federal estate tax law as previously revised in 2010, individuals can transfer to others a basic exclusionary amount of up to $5 million free of federal taxation during lifetime or at death. This figure is adjusted for inflation, so in 2012 it was $5.12 million. The American Taxpayer Relief Act of 2012 makes the $5 million exemption amount permanent and this exemption will continue to be indexed for inflation. While the exact figures are subject to this inflation indexing, the exemption is expected to be $5.34 million for 2014 and up to $7.5 million by 2020.

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. See www.taxpolicycenter.org. As previously noted, in 2011 only estates valued at over $5 million could potentially owe estate tax for deaths occurring in that year. The Tax Policy Center estimated that for deaths occurring in 2011, only about 1 in 800 would result in a taxable estate; 99.9 percent of deaths trigger no estate tax. TPC estimated that 8,600 individuals dying in 2011 left estates with a gross value of over $5 million, which would trigger the requirement to file a federal estate tax return. However, of those deaths, after allowing for deductions and credits, only an estimated 3,270 estates owed any tax. While much of the discussion on federal estate tax focuses on family farms and small businesses, less than

Revised March 2014

Iowa State University
Extension and Outreach

50 small farms and businesses – estates with farm and business assets making up at least half of gross estate and totaling $5 million or less – payed any estate tax for deaths occurring in 2011. Such estates represent just 1.2 percent of all taxable estate tax returns. TPC further estimated that small farms and businesses would pay under $10 million in estate tax for deaths occurring in 2011, less than one-tenth of 1 percentage point of the total revenue the tax would collect.

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 ($5,340,000 in 2014, 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 his or her 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, $5,340,000 in 2014. Any remaining value of the estate over $5,340,000 faces a tax rate of 40 percent.

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

1. Determine the value of the gross estate.
2. Subtract allowable deductions.
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.

Table 1. 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[1/]	$5 million or $0			1,000,000	345,800	35%
2011[2/]	5,000,000	1,730,800	35%	5,000,000	1,730,800	35%
2012[3/]	5,120,000	1,772,800	35%	5,120,000	1,772,800	35%
2013	5,250,000	2,045,800	40%	5,250,000	2,045,800	40%
2014	5,340,000	2,097,800	40%	5,340,000	2,097,800	40%

[1/] In 2010, had option to choose $5 million or $0.
[2/] 2011 and on includes portability between spouses.
[3/] 2012 and on is indexed for inflation.

Source: Internal Revenue Service, Publication 950

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

- Internal Revenue Service Publication 950 – Introduction to Estate and Gift Taxes (Revised October 2011), http://www.irs.gov/publications/p950/index.html
- Federal Estate Tax – Publication No. MT199104HR – Montana State University Extension (Revised June 2013). http://msuextension.org/publications/FamilyFinancialManagement/MT199104HR.pdf

United States Department of Agriculture

National Institute of Food and Agriculture

North Central Risk Management Education Center

This material is based upon work supported by USDA/NIFA under Award Number 2010-49200-06200.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and July 30, 1914, in cooperation with the U.S. Department of Agriculture. Cathann A. Kress, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.

Prepared by Melissa O'Rourke
farm and business management specialist
morourke@iastate.edu, 712-737-4230