Texas Agricultural Extension Service
The Texas A&M University System

RM7-6.0
10-98

Federal Estate Taxation

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The federal estate tax is an excise tax levied on the privilege of transferring property at death. Tax liability is measured by the size of the decedent's estate. Important issues relevant to understanding estate taxes are when and how property is valued for federal estate tax purposes, and what property is included in the decedent's gross estate.

When is Property Valued?

In general, property is valued for federal estate tax purposes as of the date of death. However, if the value of the estate is more than the exemption for the year of death ($625,000 for 1998), the executor can elect an alternate valuation in which the assets of the estate are valued at their fair market value as of 6 months after the decedent's death.

How is Property Valued?

Most assets are valued at fair market value. That is the price at which a willing buyer and a willing seller would exchange the property. For stored grain, for example, fair market value is what the elevator would pay. For feed on hand at death, selling price is an appropriate measure of fair market value.

Special use valuation. The only major exception to the willing buyer/willing seller test is special use valuation of land used in a farming or ranching (or other closely held) business. The executor of an estate may elect to value real property devoted to farming or ranching (or other closely held businesses) at its special use value rather than at its fair market value. The most common approach for determining the special use value of agricultural land is to obtain cash rent figures on comparable land and discount that amount by an IRS-prescribed interest rate for the part of the country in which the land is located.

To qualify for special use valuation several complex requirements must be satisfied before death. The most important pre-death requirements are:

- The farmland and farm personal property must make up at least 50 percent of the adjusted value of the gross estate, using fair market value figures.
- The farmland itself must make up at least 25 percent of the gross estate, less secured indebtedness.
- The decedent or member of the decedent's family must have had an equity interest in the farm operation at the time of death and for 5 or more of the last 8 years before death.
- The decedent or a member of the decedent's family must have been actively involved in the farm or ranch business during 5 or more of the last 8 years before the earlier of the decedent's retirement, disability, or death.
- The real estate must have been owned by the decedent or a member of the family and held for a qualified use during 5 or more years in the 8-year period ending with the decedent's death.

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- The qualified real estate must pass to the qualified heir(s) instead of being sold at death.
- The qualified heir(s) must receive a present interest in the property.
- For land owned by a partnership, 20 percent or more of the partnership's total capital interest must be in the decedent's estate or the partnership must have had 15 or fewer partners. For land owned by a corporation, 20 percent or more of the corporation's voting stock must be in the estate or the corporation must have had 15 or fewer shareholders.

An estate in which a special use valuation election is made is subjected to a 10-year period during which no eligibility rule can be violated or the estate will have to pay back all the tax benefits. This is what "recapture" means. The following are some of the possibilities and consequences of post-death recapture.

- Recapture occurs if a qualified heir disposes of the land to persons other than "members of the family" of the qualified heirs during the recapture period.
- Recapture occurs if the qualified heir does not materially participate for more than 3 years in any 8-year period that ends after death.
- Recapture is triggered if there is a change in use of the elected property.
- The qualified use test must be satisfied for the entire length of the recapture period, except for a 2-year grace period immediately following death. Each qualified heir must have an "equity interest" in the operation.

If recapture tax is triggered, the amount recaptured is the difference between what the estate would have paid without the election and what it paid with the election.

An IRS lien is imposed on all qualified farm or closely held business real property for which a special use value election has been made. The lien arises at the time the election is filed and continues until the potential liability for recapture ceases, the qualified heir dies, or the tax benefit is recaptured.

What is Included in the Gross Estate?

In general. In general, the gross estate includes all property interests owned in the decedent's name at the date of death, including the decedent's portion of tenancy-in-common property or community property and the applicable part of joint tenancy or tenancy-by-the-entirety property.

Retained interests. If an individual makes a gift of property, but keeps some powers over the property, those retained powers will pull the property back into the donor's estate. Specifically, if the transferor retains the power to revoke, alter, amend or terminate the transfer, the property remains in his estate. If the purpose of giving away property is to diminish the size of the estate so as to save federal estate tax, no powers over the property should be retained.

Powers of appointment. The gross estate includes property over which the decedent possessed a general power of appointment. A general power of appointment means the decedent had the power to designate who gets the property. The power is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or creditors of the decedent's estate. A general power is fully taxable because it pulls the property subject to the power into the power holder's estate.

Gifts within 3 years of death. Gifts made within 3 years of death are included in the gross estate only if (1) the decedent retained a life estate in the property, (2) the transfer is to take effect at death, (3) the transfer is revocable, or (4) the transfer involves life insurance policies.

Deductions From the Gross Estate

Administrative expenses. Attorney's fees, executor's fees, court costs, costs associated with the last illness, death and burial costs, debts of the decedent, and losses from fire, storm, or other casualty or theft loss occurring during estate settlement are all deductible if they are deductible under local law and are reasonable and necessary administrative expenses.

Marital deduction. The marital deduction applies to property passing to the surviving spouse. If there is no surviving spouse, there is no marital deduction. The marital deduction is 100 percent for qualified property. Thus, it is possible to entirely eliminate the federal estate tax liability upon the first spouse's death by simply leaving everything to the surviving spouse outright in a form qualifying for the marital deduction.

The family-owned business deduction (FOBD). The FOBD is modeled closely after special use valuation with many of the major tests and requirements drawn from special use valuation. However, while special use valuation applies only to land, the FOBD applies to all assets used in the farm, ranch or other closely held business. The assets involved are valued at fair market value in the traditional manner, except for land that is subject to a special use value election. In that case, the use value is the value used for FOBD purposes.

The value of qualified family-owned business interests (QFOBIs) is included in the gross estate with a maximum deduction of $675,000. If an estate includes less than $675,000 of QFOBIs, the unified credit exemption amount is increased on a dollar-for-dollar basis to the extent of the shortfall, but only up to the applicable exclusion amount otherwise available for the year of death.

A number of pre-death eligibility requirements apply.

- The decedent must have been a citizen or resident of the United States at the time of death, and the principal place of business must be in the United States.
- The aggregate value of the decedent's QFOBIs must exceed 50 percent of the adjusted gross estate.
- The decedent's QFOBIs must pass to or be acquired by qualified heirs.
- A "trade or business" must exist, and certain "passive assets" do not qualify.
- The decedent or a member of the decedent's family must have owned and materially participated in the trade or business for at least 5 of the 8 years immediately preceding the earlier of the decedent's death, disability or retirement.
- It is likely that a qualified heir must receive a present interest in the property.

The FOBD rules levy a recapture tax if, within 10 years of the decedent's death and before the qualified heir's death, a recapture event occurs. Recapture is triggered by any one of the following events:

- The heir disposes of a portion of a QFOBI other than to a member of the qualified heir's family or through a qualified conservation contribution.
- The heir or a member of the heir's family does not materially participate for more than 3 years in any 8-year period ending after death.
- There is a sale or exchange of grain or livestock in inventory, sale or exchange of machinery and equipment, or transfer of other property to persons other than members of the qualified heir's family.

An IRS lien is imposed on all qualified farm or closely held business real property for which an election has been made to exclude the property from the decedent's estate. The lien arises at the time the election is filed and continues until the possibility for recapture ceases, the qualified heir dies, or the tax benefit is recaptured.

Charitable deduction. There is an unlimited charitable deduction for property included in the decedent's gross estate that passes to a qualified charity.

The Taxable Estate

To determine a decedent's taxable estate, start with the gross estate (adjusted for gifts and gift tax within 3 years of death except for amounts covered by the federal gift tax annual exclusion) and subtract the costs of estate administration, allowable losses, the marital deduction, the FOBD (if elected), and any charitable deduction. There is a tax credit of $202,050 (for 1998) to offset gift tax during life or to be applied against estate tax at death. Taxable gifts not covered by the federal gift tax annual exclusion, marital deduction or charitable deduction are included in the taxable estate, and then any portion of the credit not already used is subtracted from the estate. This gives the point at which to begin figuring federal estate tax on the graduated tax schedule.

The Unified Credit

Once all items are included in the gross estate and all appropriate deductions are taken, the federal estate tax is computed. After that, certain credits may be subtracted. The most valuable credit is the unified credit. For deaths in 1998, the tax credit is $202,050. If an estate has a tax liability greater than the unified credit, the federal estate tax applies. Everything is covered up to $202,050 (for deaths in 1998), which shelters the equivalent of $625,000 worth of property. A taxable estate of $625,000 owes no federal estate tax because it will all be covered by the unified credit.

Planning to Minimize Federal Estate Taxes

Different strategies can be used to transfer property to subsequent generations at the least tax cost. The best strategy depends upon the objectives to be accomplished.

In Texas, for additional information on this topic contact Wayne Hayenga, Professor and Extension Economist, The Texas A&M University System, College Station, Texas 77843-2124. Phone: (409) 845-2226, Fax: (409) 847-9374.

This publication is adapted from Roger A. McEowen and Neil E. Harl. 1998. **Principles of Agricultural Law**, Agricultural Law Press, Eugene, OR. Section 8.05.

Partial funding support has been provided by the Texas Wheat Producers Board, Texas Corn Producers Board, and the Texas Farm Bureau.

Produced by Agricultural Communications, The Texas A&M University System

Issued in furtherance of Cooperative Extension Work in Agriculture and Home Economics, Acts of Congress of May 8, 1914, as amended, and June 30, 1914, in cooperation with the United States Department of Agriculture. Chester P. Fehlis, Deputy Director, Texas Agricultural Extension Service, The Texas A&M University System.

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