



Federal Estate Taxation

Curriculum Guide

I. Goals and Objectives

- A. Learn what property is valued, how property is valued, and when property is valued for federal estate tax purposes.
- B. Learn about special use valuation.
- C. Learn about deductions from the gross estate and the unified credit.

II. Description/Highlights

General Approach

- A. Perhaps the easiest way to arrive at a basic understanding of the federal estate tax is to determine when property is valued for federal estate purposes, how property is valued, and what property is included in a decedent's gross estate. As noted, property is valued as of the date of death or, by election, at six months after death. Property is valued at fair market value, with the major exception being special use valuation. All ownership interests of the decedent as of the date of the decedent's death are included in the decedent's estate to the extent of the decedent's ownership interest in a particular asset.

Supplemental Information

- B. Special use valuation is the major exception to the general rule that assets are valued at fair market value as of the decedent's death. Special use valuation, while it has the potential to be an enormous federal estate tax saver, cannot reduce the gross estate by more than \$750,000 (this amount is indexed for inflation for deaths after 1998). There are two valuation methods for determining the special use value of agricultural real estate. The most popular of these methods is termed the rent capitalization approach. This approach involves taking the average annual gross cash rent per acre minus property tax on comparable land for the last five full calendar years before death and dividing the difference by the average annual effective Farm Credit Bank (FCB) interest rate for the last five years. The IRS publishes the figures for the denominator every year by FCB district. The estate arrives at the numerator by obtaining cash rent figures on comparable land. Thus, the estate looks for cash rented land that is comparable to that of the decedent and obtains from those tracts the cash rent figure and the property tax

figure. The cash rent capitalization approach has historically produced values from 35 to 60 percent of fair market value.

- C. Whether a special use valuation election is made in a particular estate should be carefully considered. The post-death requirements must be satisfied for ten years after the date of the decedent's death. The failure to satisfy any one of the requirements triggers recapture tax. Perhaps the most troublesome post-death requirement is the qualified use test. Before legislation enacted in 1997, there could be no cash renting in the after-death period with two exceptions. The exceptions were for surviving spouses who could cash rent to members of the surviving spouse's family and for cash renting during a two-year grace period which extended for two years after the date of death. However, legislation enacted in 1997 specified that rental of land on a "net cash basis" by a lineal descendant of the decedent to a member of the family of the lineal descendant does not cause recapture. The provision was made retroactive for leases entered into after December 31, 1976.
- D. **Deductions from the gross estate.** *The family-owned business deduction (FOBD).* While the FOBD is patterned closely after special use valuation, it differs in a number of important ways. For instance, "passive assets" do not qualify for the FOBBED. Disqualified assets include rents not derived from the active conduct of a trade or business such as under a cash rent lease or a nonmaterial participation share lease of assets with minimal involvement by the decedent. A cash rent lease to a family member or to a family entity owned by members of the decedent's family does not preclude eligibility.
- E. A FOBBED election should be carefully considered. A ten-year post-death recapture period applies. If any of the post-death requirements are not satisfied during the recapture period, the benefits of the FOBBED election are lost.
- F. An important point is that the unified credit will vary from estate to estate depending on the amount of QFOBI deductions. The maximum FOBBED amount is set at \$675,000 and the exemption equivalent of the unified credit in estates electing the FOBBED is set at \$625,000 and continues at that level. It should be noted that for estates not electing the FOBBED, the exemption equivalent of the unified credit is scheduled to rise to \$1 million for deaths after 1996. Thus, the combined amount is \$1,300,000 for 1998 and thereafter. Review the example.
- G. **The unified credit.** The unified credit is available to offset taxable gifts during life or estate tax at death. To the extent it has not been used to offset taxable gifts during life, it is available to offset estate taxes at death. Using the overhead visuals, review the unified credit table which is scheduled to increase over the next few years.

Fundamental Approaches to Federal Estate Tax Savings.

- H. There are three basic approaches to saving federal estate tax. One approach is for those estates where the combined wealth of the husband and wife is expected to be no greater than the exemption equivalent of the available unified credit at the death of the surviving spouse. The property can be left outright or by survivorship designation to the surviving spouse or left in trust and there will be no federal estate tax. Another approach applies when the combined spousal wealth is expected to be no greater than twice the exemption equivalent of the available unified credit at the surviving spouse's death. The estates are roughly balanced during life between the spouses with each spouse leaving the other a life estate. By design, none of the property qualifies for the marital deduction upon the first spouse's death. Owning property in joint tenancy form is not desirable. A third approach is for those estates expected to exceed twice the exemption equivalent of the available unified credit at the death of the surviving spouse. The optimal strategy may involve balancing the estates during life between the spouses (severing joint tenancy property), creating a partial marital deduction at the death of the first spouse and leaving the remaining property of the first spouse in life estate form for the survivor.

III. Potential Speakers

- A. Local attorney
- B. Extension tax and law specialist

IV. Review Questions

- A. What is the exception to the general rule that assets are valued at fair market value as of the descendant's death.

Answer: For agricultural real estate a "special use valuation" method is allowed for valuing the property.

IV. For More Details

None available at this time.



Valuing Property

- ! Date of death
- ! 6 months after death
- ! Fair market value
 - ☞ Special Use Valuation
- ! Property included in the valuation

Special Use Valuation

- ! Reduction limited to \$750,000
- ! Two special use valuation methods of agricultural real estate
- ! Rent capitalization approach

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Deductions From Gross Estate

- ! Family-owned business deduction (FOBBED)
- ! Passive assets do not qualify
- ! 10 year post-death recapture period applies
- ! Other

The following example illustrates the interplay of the unified credit and the FOBBED.

Example - Jane Smith, a widow, dies in 2000 with a gross estate of \$1,400,000. Jane's estate included \$665,000 of qualified family-owned business interests. Jane's estate elects to use the FOBBED. Jane did not make any taxable gifts during her life. The federal estate tax for Jane's estate would be calculated as follows:

Gross Estate	\$1,400,000
Debts and Administrative Expenses	70,000
FOBBED	<u>\$ 665,000</u>
Taxable Estate	\$ 665,000
Adjusted Taxable Gifts	<u>-0-</u>
Taxable Amount	<u>\$ 665,000</u>
Tentative Tax	\$ 216,850
Gift Taxes Payable	<u>-0-</u>
Gross Estate Tax	\$ 216,850
Unified Credit (exemption equivalent of \$635,000)	<u>205,750</u>
Estate Tax after Unified Credit	\$ 11,100

Note: While the exemption equivalent of the unified credit is \$625,000 for estates that also elect the FOBBED, Jane's estate only had \$665,000 of qualified family-owned business interests. This is \$10,000 less than the allowable limit of \$675,000. The unified credit exemption is increased dollar-for-dollar up to the allowable limit to the extent the FOBBED is less than \$675,000. Thus, the exemption equivalent of the unified credit in Jane's estate is \$635,000 (\$625,000 + \$10,000).

Source: Roger A. McEowen and Neil E. Harl, **Principles of Agricultural Law**, Agricultural Law Press, Eugene, OR, 1998, pp. 8-52.11.

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Unified Credit

- ! Offset taxable gifts
- ! May offset estate taxes at death
- ! The unified credit amount is scheduled to increase over the next few years as follows:

Year	Unified Credit	Exemption Equivalent
1998	\$202,050	\$625,000
1999	211,300	650,000
2000	220,550	675,000
2001	220,550	675,000
2002	229,800	700,000
2003	229,800	700,000
2004	287,300	850,000
2005	326,300	950,000
2006 & later	345,800	1,000,000



Approaches to Federal Estate Tax Savings Three Situations

- ! Combined husband & wife wealth less than exemption equivalent of available unified credit at the death of surviving spouse.

- ! Combined husband & wife wealth less than twice the exemption equivalent of available unified credit at the surviving spouse's death.

- ! Estate value exceeds twice the exemption equivalent of available unified credit at the death of the surviving spouse.