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Estate Planning in North Dakota: THE BASICS

Gift and Estate Taxes

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Estate tax is a complex topic. Some common questions regarding this topic are: "When I die, will my family have to pay any estate tax as they inherit my property?" "Is there anything I can do now to reduce the tax obligation of my estate at my death?" "If I give away my property now, will I have to pay tax?"

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The purpose of this publication is to answer some of these questions by introducing the basics of federal estate and gift taxes. Because tax law is complex and every family has unique needs, working with an appropriate professional is important to develop a tax strategy within an overall estate plan. This publication is intended as an informative introduction to the subject of federal estate and gift taxes. Congress often changes tax laws, so a plan that makes sense today may need to be reviewed and revised in the future.

This publication does not discuss whether an individual will be subject to any state estate or gift taxes. Consult an appropriate professional for information about state estate and gift taxes.

"Is there anything I can do now to reduce the tax obligation of my estate at my death?"

Estates valued up to $5 million can be transferred at death or during the owner's lifetime without federal estate or gift tax liability. (The values used in this publication apply for individuals who die during 2011 and 2012. After Dec. 31, 2012, laws in this area will change dramatically unless Congress takes action.)

The allowance to transfer $5 million of property is due to the ***unified credit*** and is discussed in more detail throughout this publication.

For many people, the $5 million allowance takes care of any concern about estate tax. But the complexity of federal estate and gift tax law warrants additional discussion even if a person thinks the value of his or her estate will be less than the $5 million. Understanding the fundamental features of estate and gift taxes should help assure that potential tax liabilities are appropriately considered in developing an estate plan.

People who made gifts prior to 1976 should consult a tax adviser because these transfers are subject to different rules than are in effect today.

"If I give away my property now, will I have to pay tax?"

A strategy for people who might incur an estate tax is to give away some property during their lifetime so they own less property at the time of their death. However, individuals who give away property during their lifetime may be subject to a gift tax.

If a gift tax is imposed, it is paid by the donor; that is, the person who gives away his or her property. The recipient of a gift is not subject to any tax (no gift tax or any income tax). The amount of gift tax that a donor needs to pay is based on the value of the property at the time of the gift.

While the general rule is that any gift is a taxable gift, that rule has some exceptions. For instance, the following gifts generally are not taxable gifts:

- Gifts to charities
  - *Example:* A property owner decides to give $17,000 to a charity. None of this gift would be considered a taxable gift. (Technically, the gift to charity is a taxable gift, but individuals receive gift tax deductions for the full value of any gift to charity.)
- Gifts to your spouse
  - *Example:* A property owner decides to give $30,000 to his or her spouse. None of this gift would be considered a taxable gift.
- Gifts that are less than the ***annual exclusion*** for the calendar year (the annual exclusion amount is adjusted for inflation and currently is $13,000)
  - *Example:* A property owner decides to give $15,000 to a son or daughter in 2011. The first $13,000 of this gift is not subject to gift tax due to the annual exclusion; only the $2,000 that exceeds the annual exclusion is considered a taxable gift. This property owner then can give another $13,000 to the same son or daughter the following year without gift tax.
  - *Example:* A property owner decides to give $10,000 each to three individuals; none of these gifts would be considered taxable because each gift is less than the annual exclusion.
  - *Example:* A married couple decides to give $22,000 to an individual; none of this gift would be considered taxable due to the combined annual exclusions of the husband and wife.
  - Additional information about the annual exclusion:
    - A property owner and the recipient of the gift do not need to be related for the gift to qualify for an annual exclusion.
    - The number of annual exclusions a property owner can use in a year is not limited. If someone wanted to give $13,000 to each person in his or her social circle, these would not be taxable gifts.
    - The annual exclusion is available every year during a person's life.

- Tuition or medical expenses paid directly to a medical or educational institution for someone
  - *Example:* A grandparent directly pays a granddaughter's college tuition for a semester (rather than giving the cash to the granddaughter). In an effort to encourage such gifts, Congress has defined the tuition payment as a nontaxable gift to the granddaughter.
- Gifts to a political organization.

The exceptions actually cover most of the "normal" gifts a taxpayer might make during the year. Only if an exception does not apply will the gift be subject to a gift tax.

Due to the unified credit of being able to transfer $5 million without tax, the donor will not pay any gift taxes during his or her lifetime unless his or her taxable gifts exceed $5 million. Accordingly, many people do not pay gift taxes.

However, making taxable gifts during one's lifetime reduces the amount of property that can transfer without estate tax at the time of the donor's death. The relationship between gift tax and estate tax is discussed more fully in another section.

"When I die, will my family have any tax obligations as they inherit my estate?"

Property transferred at death is subject to a federal estate tax. This tax is owed and paid by the estate of the deceased. Anyone who receives money or property from an estate need not pay income tax on the value of what was received.

The amount of estate tax reflects the value of the property owned when the person dies: The greater the value, the greater the estate tax. Any estate tax that may be owed is paid from the estate before the remaining property is transferred to the heirs. The recipient of the inheritance is not subject to any tax (no estate tax or any income tax). That is the basic or general rule, but like all rules, it has many exceptions, as discussed in this publication.

The first major exception to the "general" rules is the unified credit (as introduced in another section) that allows each person to transfer $5 million of property to others without tax. A key question becomes: "Is my ***taxable estate*** likely to exceed $5 million?"

"What is included in my taxable estate?"

Determining the value of the ***gross estate*** is the starting point when calculating the taxable estate and federal estate taxes. For tax purposes, the gross estate includes:

- All property (real and personal) owned solely by the decedent at the time of his or her death
- The decedent's proportionate share of property held in tenancy in common
  - *Example:* The decedent owns 60 percent of a tract of land; the other 40 percent is owned by someone else. The land is valued at $300,000 when the decedent dies; $180,000 ($300,000 x .6) would be included in the decedent's estate
- One-half of property held by the decedent in joint tenancy with his or her spouse
- All of the property held by the decedent in joint tenancy with anyone other than his or her spouse except to the extent the surviving joint tenant(s) paid for acquiring or improving the property
  - *Example:* The decedent is one of three co-owners of a tract of land with a value of $450,000; all $450,000 would be included in the decedent's estate except that records show the two surviving co-owners paid half of the cost of the property when it was acquired; therefore, only $225,000 ($450,000 x .5) would be included in the decedent's estate.

- Life insurance proceeds payable to the estate (or for the benefit of the estate)
- Life insurance proceeds payable to others where the decedent retained "incidents of ownership" (such as the power to change beneficiaries, use the policy for a loan, or surrender or cancel the policy)
- Property transferred by the decedent before death but the decedent retained a life estate or some interest, or over which the decedent retained power or control
- The value of an annuity or other payment receivable by a beneficiary as a result of surviving the decedent if the annuity or other payment is attributable to contributions made by the decedent or the decedent's employer
- Property from a marital deduction trust created by the decedent's predeceased spouse
- Gifts of life insurance made within three years of death
- Gift taxes paid on gifts made by the decedent within three years of death

While these different types of property can be confusing, every person should strive to know, on an on-going basis, what property he or she owns, what property he or she co-owns, the form of ownership of any co-owned property and the value of his or her ownership/property interests.

Property included in the estate is valued at its fair market value as of the decedent's date of death. However, if certain conditions are met, land used for ***farming or a closely held business*** may be valued at its ***use value***, which may be lower than the land's fair market value.

- The intent of allowing a lower *use value* for land is to provide an estate tax break to families who own and operate a farm business. The estate tax break should provide the family a better opportunity to continue operating the farm business as it is transferred from one generation to the next.
- *Use value* is calculated by capitalizing the local cash rental rate for farmland; that is, by dividing the cash rental rate by the interest rate.
- During times of rapidly rising land values, farm families may benefit by assuring the land qualifies for *use value* at the time of the owner's death.
- But *use value* is available only if the family meets a variety of requirements **both before and after the death of the landowner**. Consult competent legal counsel to learn more about *use value* for farmland.

If you are confused about the type of ownership interest you have in your property or the categorization of your property, you should consult an appropriate professional.

The ***taxable estate*** then is determined by making deductions from the gross estate. For example, following the decedent's death, the personal representative of the estate is obligated to use a portion of the estate's property to pay any debts owed by the decedent. These payments reduce the amount of property that will pass on to heirs, so these amounts are deducted from the value of the estate. ***Deductions*** include:

- The decedent's debts and claims, liens and mortgages against the estate
- The decedent's medical and "last illness" expenses and funeral expenses
- Costs of administering the estate, such as fees for appraisal or legal services
- Any property lost from the estate due to theft, fire, storm or other casualties during settlement of the estate

These deductions have some limitations that the personal representative will want to review with an appropriate tax adviser as the estate is being settled.

In addition, the value of any property left to a surviving spouse is not subject to estate tax in the decedent's estate (referred to as the ***marital deduction***).

- The *marital deduction* is equal to the full value of 1) the property passing outright to the surviving spouse, (such as by will, through joint tenancy, or under the state law of descent and distribution) and 2) property passing in other forms that satisfy the marital deduction requirements of the Internal Revenue Code.

Finally, the value of any property bequeathed or devised to charitable organizations is not subject to estate tax (referred to as ***charitable deductions***).

Unified Estate/Gift Tax Credit

Due to the ***unified credit*** in federal and gift tax law, property valued up to $5 million can be transferred at death or gifted away before the decedent's death without federal estate or gift tax liability.

Example:

- The decedent dies owning property valued at $6.9 million (gross estate).
- Debts total $400,000 and the decedent bequeaths $1 million to the surviving spouse. The remaining property is bequeathed to the decedent's children.
- The taxable estate would be $5.5 million ($6.9 million – ($400,000 + $1 million)).
- However, $5 million can transfer without estate tax, so only $500,000 would be subject to estate tax.

In this example, the decedent could have planned to bequeath $1.5 million to the surviving spouse or $500,000 to a charity and NO property would be subject to estate tax. The property owner is responsible for making this decision (that is, planning his or her estate). Some situations may occur in which a property owner plans to subject some of his or her estate to taxes to achieve other goals, such as leaving more property to his or her children.

However, if some of the $5 million unified credit is used to avoid paying gift taxes during the individual's lifetime, less than $5 million in property can be passed on "tax free" at the time of death.

Example: A property owner gives $500,000 to a son or daughter so the son or daughter can begin a business. Of this gift, $487,000 would be considered a taxable gift ($500,000 minus the $13,000 annual exclusion). This taxable gift is NOT likely to require a gift tax payment to the government due to the ***unified credit***. But when the property owner dies several years later, only $4,513,000 ($5 million - $487,000) in property can pass free of estate tax at that time because $487,000 already had passed tax-free several years earlier when the $500,000 gift was made.

Beginning in 2011, a surviving spouse is allowed to pass property without tax by using his or her deceased spouse's unused unified credit. For example, a husband predeceases his wife and has an estate worth $2 million. When the wife subsequently dies, up to $8 million of her estate can be exempt from federal estate tax. The $8 million allowance reflects her $5 million allowance and $3 million from her deceased husband's unused allowance. With this provision, a married couple is able to transfer as much as $10 million from their two estates without federal estate tax. Note that the ability to use the deceased spouse's unused allowance will sunset on Dec. 31, 2012.

In an effort to prevent a family from having to pay estate tax on property too often, a credit is allowed for ***prior transfers*** on which federal estate taxes have been paid on the property within the last 10 years. For example, Grandmother died in 2007 and some of her estate was subject to estate tax as it passed to her son. The son then dies in 2012 and the property will be subject to an estate tax again as it passes to the granddaughter. In this situation, Congress feels that a family should not be subject to an estate tax on the same wealth in such a short time. Accordingly, the son's estate tax will be reduced to reflect that the wealth had been subject to an estate tax several years earlier when the grandmother died.

"What if someone died in 2010 while the federal estate tax temporarily was repealed?"

Personal representatives of estates whose decedents died in 2010 should consult a tax adviser. Because the previous estate tax expired in 2009 and the current estate tax did not take effect until 2011, estates of decedent's dying in 2010 are subject to special, and often complex, options.

"What else is important to know?"

As stated above, Congress does not want wealth to be subject to an estate tax too often; however, Congress wants wealth to be subject to an estate tax each generation. Accordingly, the tax law includes a provision called the ***"generation-skipping tax"*** that imposes an estate tax if a family tries to "skip a generation." For example, Grandfather has property and wants to bequeath it to the family; however, the son and daughter do not need the wealth. If they were to receive it, they likely would hold it as investments and eventually transfer it to the grandchildren. If the family agrees that is the probable outcome, the grandfather may decide to bequeath the property directly to the grandchildren and not subject the wealth to an estate tax in the middle ("skipped") generation.

To discourage this practice (which primarily benefits the wealthiest families), Congress imposes a tax when a "generation is skipped." Consult your tax adviser if you are interested in exploring considerable bequests to grandchildren. The "generation skipping" tax applies to transfers that "skip" one or more generations (such as from grandparent to grandchild) unless the transfer goes to the children of a deceased son or daughter.

Currently, a ***federal estate tax return*** is required for any decedent whose gross estate exceeds $5 million. The return generally is due and the entire tax payable within nine months after death. However, if filing a reasonably complete return before the due date is impossible or impractical for the personal representative, the Internal Revenue Service may grant a six-month filing extension.

Conclusion

This publication introduces federal gift and estate taxes. Gift and estate tax law is complex and every family is unique, so working with a professional to develop an estate plan, as well as a tax strategy within that estate plan, is important. Revisiting your estate plan often also is important because tax laws can be changed and any changes could significantly affect the plans you carefully have set in place for your family.

References

This publication is based on materials originally developed by Marsha A. Goetting, Extension Family Economics Specialist, Montana State University, Bozeman.

Other sources include:

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IRS Publication 950 www.irs.gov/publications/p950/index.html

This publication is not intended to provide a substitute for legal advice. Nor is it intended to serve as a complete and exhaustive text on estate planning. Rather, it is designed to provide basic, general information about the fundamentals of estate planning so you will be better prepared to work with professional advisers to design and implement an effective estate plan.

Information in this publication is based on the laws in force on the date of publication.

For more information on this and other topics, see www.ag.ndsu.edu

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