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## NF96-143 Federal Estate and Gift Taxes

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# NebFact



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## Federal Estate and Gift Taxes

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Understanding what part of an estate is taxed, how the tax is figured and who pays the estate taxes can be confusing. This NebFact will help clear up the confusion by explaining the key terms used when determining estate and gift taxes.

The estate of the person who died (decendent) is liable for the tax on the taxable estate. However, the beneficiaries of the estate may have to pay the tax if the estate does not pay it when it is due. This can occur when part of the estate's assets need to be sold in order to pay the tax, and the beneficiaries choose to pay the tax themselves, rather than have the estate sell any assets.

While Federal Estate Taxes and Gift Taxes are different, the Unified Rate Schedule combines the taxation of estates with the taxation of gifts. Currently (1993), the *unified credit* is \$192,800 which allows for \$600,000 of estate to pass untaxed to heirs, providing that none of the credit was used while the person was living to offset the gift taxes due. Gift taxes must be paid on gifts which exceed \$10,000 per year per recipient unless part of the unified credit is used to offset the gift tax due. Any gift credit used reduces the amount of the unified credit available later for offsetting estate taxes.

Tax law defines the gross estate and the taxable estate of the decendent. The tentative estate tax due is figured from the taxable estate. Various credits are applied to the tentative estate tax to determine the actual estate tax due.

The terms, gross estate, taxable estate and the various credits allowed to estates when computing the federal estate tax due, are explained in this NebFact. Also included is information on filing the tax form, paying the tax and some planning considerations. For information on state death and inheritance taxes see *A Summary of Nebraska Law on State Inheritance and Estate Tax*, NebGuide G85-757.

### Gross Estate

Before tax can be assessed, the value of the estate must be computed.

The value of the estate is determined as of the date of death or, if an alternative valuation method is used, up to six months after the date of death. (See NebFact NF93-145, *Special-Use and Alternate Valuation of Estates*, for a more complete description of alternative valuation methods.)

The gross estate includes assets that fall into the following seven categories:

- **Property owned by the decedent at the time of death.** The value of all the property owned by the decedent at the time of death is included in the gross estate.
- **Property transferred before death.** The gross estate includes the value of property that was transferred before death if it was transferred in one of the following ways:
  1. Transfers with retained life estate,
  2. Transfers taking effect at death, and
  3. Revocable transfers.

*Transfers with retained life estate* occur when property is transferred before the death of the transferor, but the transferor keeps enjoyment of the property, or reserves certain rights or interests in it. Rights or interests which would indicate a transfer with retained life estate are the right to use, possess, receive income or other enjoyment, or name persons who will possess or enjoy the transferred property or its income. Transfers with retained life estate are valued at the time of death of the transferor and becomes part of the gross estate.

*Transfers taking effect at death* add to the gross estate the value of any property interests transferred by the decedent if all of the following conditions are met:

1. the beneficiaries could have possessed or enjoyed the transferred property through ownership of it, only by surviving the decedent,
2. the decedent kept a reversionary interest in the property. Reversionary interest generally refers to any right under which the transferred property will or may be returned to the grantor. The method of determining the value of reversionary interest is detailed in IRS Publication 448, *Federal Estate and Gift Taxes*.
3. the value of the reversionary interest immediately before death was more than 5 percent of the value of the entire property.

*Revocable Transfers* are when the decedent gave property in trust and was the trustee with the power to revoke the trust. This does not apply if the transfer was made for its full worth in money or something of equal value.

- **Annuities.** The gross estate includes the value of an annuity or other payment that a *beneficiary* is due to receive because he or she survives the decedent. An annuity which the decedent received while living but which terminated upon death is not included in the gross estate.
- **Proceeds of life insurance.** The gross estate includes the proceeds from life insurance on the decedent's life if :
  1. the proceeds are receivable by the estate, or
  2. the proceeds are receivable by another for the benefit of the estate, or
  3. the decedent possessed incidents of ownership in the policy.

*Incidents of ownership* means the right of the insured or the insured's estate to the economic benefits of the policy. It includes the power to change beneficiaries, to revoke an assignment, to obtain a loan against the surrender value, to pledge the policy for a loan, or to surrender or cancel

the policy.

If a decedent made a completed gift of a life insurance policy on his or her life, and all incidents of ownership, within three years of death, the proceeds of the life insurance policy are included in the gross estate of the decedent. If the transfer were made more than three years prior to death, the proceeds of the life insurance policy are not included in the decedent's gross estate.

The proceeds of insurance owned by a partnership on the life of a partner are not included in the insured partner's gross estate if the proceeds are payable to or for the benefit of the partnership.

- **Joint interests.** Joint interests involve property owned by more than one person. At the time of death of one owner, the other owner receives full ownership rights to the property. The gross estate of the decedent includes the full value of joint interests. If the executor of the estate can prove that part of the property held in joint tenancy was paid for by the surviving co-owner, or was given specifically to the surviving co-owner, that portion of the joint interest is not included in the gross estate of the decedent.

If the joint tenants are spouses the ownership is considered *qualified* joint interests. The gross estate of the decedent only includes one-half of the value of qualified joint interests.

- **Gift taxes.** The gross estate includes the amount of any gift tax paid by the decedent or the estate on any gift made by the decedent or the decedent's spouse during the three-year period ending on the date of the decedent's death. In many cases a credit will be given for the value of this gift tax when computing the estate tax due.
- **Powers of appointment.** The gross estate includes the value of property interests over which the decedent had a power of appointment. A power of appointment determines who will own or enjoy the property subject to the power and when they will own or enjoy it.

The gross estate does not include:

1. property that the decedent owned at death that could not be transferred by a will or by the intestacy laws, such as a life estate created by another;
2. property that was transferred for its full worth (sold) prior to death.

## Taxable Estate

The taxable estate is the gross estate minus the following:

1. **administration and funeral expenses;**
2. **claims against the estate**, such as medical expenses and taxes accrued by the decedent prior to death;
3. **any outstanding obligations** (such as mortgages) on the property if the value of the property is included in the gross estate;
4. **marital deduction**, including property passing to the surviving spouse due to joint tenancy with right of survivorship and the benefits of insurance upon the decedent's life;
5. **charitable contributions** specified by the will;
6. **casualty and theft losses** which occurred to the estate during the settlement of the estate and which were not covered by insurance.

## Credits Against the Estate Tax

A gross estate tax is calculated using the taxable estate and a tax table. The following credits are deducted from the gross estate tax to determine the net estate tax payable:

1. **Unified credit.** The amount of the unified credit per individual is currently (1993) \$192,800. The amount of the unified credit available to offset inheritance taxes may be reduced if, prior to death, the decedent gave gifts and used part of the unified credit to offset the gift taxes due.

The amount of the unified credit claimed may not be more than the amount of the tax imposed. The excess unused unified credit may not be claimed as a refund.

2. **Credit for state death taxes.** A credit is allowed for any inheritance or estate tax actually paid to any state on property included in the gross estate of the decedent.
3. **Credit for gift taxes.** No credit is allowed for any gift tax paid on gifts made after 1976. Credit is allowed against the estate tax for the federal gift tax paid on a gift made by a decedent prior to 1976, if the property is included in the gross estate. The credit is limited to the lesser of:
  - gift tax paid on the gift which is included in the gross estate, or
  - the amount of estate tax to be paid on the gift that is part of the gross estate.
4. **Credit for tax on prior transfers.** Credit is allowed against the gross estate tax for federal estate taxes paid on the transfer of property to the decedent from a transferor who died within 10 years before or two years after the decedent's death. The credit is limited to the lesser of:
  - the amount of the federal estate tax attributable to the transferred property in the transferor's estate, or
  - the amount of the federal estate tax attributable to the transferred property in the decedent's estate.
5. **Credit for foreign death taxes.** Credit is allowed against the gross estate tax for any estate or inheritance taxes actually paid by the decedent's estate to any foreign country.

## Estate Tax Payment

The personal representative of the estate is responsible for filing IRS Form 706, *United States Estate Tax Return*, within nine months of the decedent's death unless an extension of time for filing has been granted. Form 706 needs to be filed only if the gross estate plus adjusted taxable gifts and specific exemptions of the decedent is valued at \$600,000 or more. The penalty for late filing is 5 percent per month, up to 25 percent of the tax required, unless reasonable cause is shown.

Payment of the tax is due when the return is due. An extension of time for filing does not extend the due date for paying the tax. An extension of time to pay can be obtained by filing Form 4768, *Application for Extension of Time to File U.S. Estate Tax Return and/or Pay Estate Tax*, if reasonable cause can be shown. Installment payment of taxes are also permissible if the estate consists of certain kinds of property. See NebFact 93-146, *Delayed Payment of Federal Estate Taxes*, for a more complete description of the methods available for delaying payment of federal estate taxes. Penalty for not paying the estate tax is 1/2 of 1 percent per month, up to 25 percent, of the unpaid amount.

## Factors to Consider When Estate Planning

Estate planning to reduce taxes is critical for those persons whose taxable estate is valued at more than \$600,000 because the unified credit of \$192,800 allows \$600,000 of estate to pass on to heirs tax free. For persons who have made taxable lifetime gifts, estate planning to reduce taxes may be necessary even if the estate is valued at less than \$600,000.

Couples whose combined estates are worth more than \$600,000 should consider owning assets as tenants in common, rather than in joint tenancy, in order to avoid paying federal estate tax or to reduce the amount paid. Upon the death of one spouse, a testamentary trust can be used to give a surviving spouse lifetime use of the assets held in tenants in common.

Couples whose combined estates are valued at more than \$1,200,000 may be unable to completely avoid paying federal estate taxes. Special-use valuation of qualifying assets can reduce the value of the estate and thereby reduce the estate tax due. Giving \$10,000 of tax free gifts per year to individuals is one way of distributing assets to heirs which reduces the value of the estate and reduces the tax due. If more than \$10,000 is given to any individual in any one year, either a gift tax must be paid or the part of the unified credit must be used to avoid paying the gift tax. If part of the unified credit is used, this reduces the amount available to offset estate taxes at death.

Because estate taxes are based on the value of the estate at the time of death it is important to review your estate plan periodically as the value of your assets changes. Life insurance can be used as a way of helping pay estate taxes. Life insurance provides cash so that the non-cash assets (such as a business) of the decedent will not have to be sold to pay the tax.

Giving gifts to charity either before or after death also reduces estate taxes by reducing the taxable estate value. Property transferred before death with retained life estate, or taking effect at death is helpful in making sure that the person you want to receive your assets does so. It may not reduce the estate tax bill due.

### **Additional References:**

IRS Publication 448, *Federal Estate and Gift Taxes*

The information contained in this NebFact is for educational purposes only. Tax is complicated and the information presented here has necessarily been simplified. See a tax consultant for specific questions.

### **Estate Tax Computation**

An idea of the amount of federal estate tax that would be due can be obtained by filling out the table below.

#### **Estimated Federal Estate Tax Computation Table**

Gross Estate	\$
Debts, administrative expenses and deductions	-
The taxable amount	=
Tentative Tax on the taxable amount (from the Unified Rate Schedule)	
Various credits (including the Unified Credit)	-

Net Estate Tax	=
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### Federal Unified Estate and Gift Tax Rate Schedule

<i>Taxable amount equal or more than — (1)</i>	<i>Taxable amount less than — (2)</i>	<i>Tax on amount in column 1 (3)</i>	<i>Rate of tax on excess over amount in column 1 (4)</i>
0			(Percent)
10,000	10,000	0	18
20,000	20,000	1,800	20
40,000	40,000	3,800	22
60,000	60,000	8,200	24
80,000	80,000	13,000	26
100,000	100,000	18,200	28
150,000	150,000	23,800	30
250,000	250,000	38,800	32
500,000	500,000	70,800	34
750,000	750,000	115,800	37
1,000,000	1,000,000	248,300	39
1,250,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	2,500,000	780,800	49
2,500,000	3,000,000	1,025,800	53
3,000,000	—	1,290,800	55

Note: Taxable estates larger than \$10,000,000 are subject to a 5 percent surcharge on the amount of the estate between \$10,000,000 and \$21,040,000.

***File NF143 under FARM MANAGEMENT***

***F-2, Estate Planning***

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