Federal Gift and Estate Tax Changes: Explanation, Comments, and Planning for the 80s

Gerald A. Harrison
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Purdue University • Cooperative Extension Service • West Lafayette, Indiana 47907
FEDERAL GIFT AND ESTATE TAX CHANGES:
EXPLANATION, COMMENTS AND PLANNING FOR THE 80's

by

Gerald A. Harrison
Extension Economist

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FEDERAL GIFT AND ESTATE TAX CHANGES: EXPLANATION, COMMENTS AND PLANNING FOR THE 80's

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Gerald A. Harrison*
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On August 13, 1981 the Economic Recovery Tax Act of 1981 (ERTA) became law by President Reagan's signature. Numerous provisions change or adjust the federal taxation of lifetime gifts and decedents' estates. Most of the changes are extensions of or amendments to the features added in the Tax Reform Act of 1976 (TRA). For example, the unified transfer tax schedule, unified credit and alternate valuation for farmland were TRA features that were all amended.

The new 100% marital deduction for gift and estate transfers and associated qualified terminal interest property provisions may be the most significant and probably most tempting provisions in the '81 Act. In addition, ERTA includes a major adjustment in the rule concerning the inclusion of marital joint property in the estate tax return of a decedent spouse. Starting in 1981, only 50% of the value of joint tenant property will be included in the federal estate tax gross estate.

An expanded marital deduction and the 50% rule for joint property, also represent another legislative response of a growing concern over the “widow's tax.” The marital deduction was expanded modestly in TRA-76 and attempts were made in TRA-76 and again 1978 in legislation to ease the problem of taxing marital joint property. Couples with modest and larger estates should continue to evaluate carefully any continued use of joint ownership of assets as well as plans to take advantage of the expanded marital deduction. Both of these features tend to encourage large values subject to estate tax in the estate of a surviving spouse.

TRA-76 inaugurated a dramatic change to federal gift and estate taxation by introducing a unified schedule of rates. To illustrate using Table 1 the tentative transfer tax on a tax base of $800,000 would be $248,300 plus 39% of $50,000 for a total of $267,800.

ERTA-81 reduces the rates for gift or estate values which exceed $2.5 million from the highest current rate of 70% until by 1985 all tax base values above $2.5 million will be taxed at a rate of 50%.

Table 1. Unified federal gift and estate tax schedule: 1977-81.

<table>
<thead>
<tr>
<th>Transfer Tax Base</th>
<th>Tax on amount in column 1</th>
<th>Tax rate on excess of amount in column 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>OF (1)</td>
<td>TO (2)</td>
<td>(3)</td>
</tr>
<tr>
<td>$ 0</td>
<td>$ 10,000</td>
<td>$ 1,800</td>
</tr>
<tr>
<td>10,000</td>
<td>20,000</td>
<td>3,800</td>
</tr>
<tr>
<td>20,000</td>
<td>40,000</td>
<td>8,200</td>
</tr>
<tr>
<td>40,000</td>
<td>60,000</td>
<td>13,000</td>
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<tr>
<td>60,000</td>
<td>80,000</td>
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<tr>
<td>750,000</td>
<td>1,000,000</td>
<td>345,800</td>
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<tr>
<td>1,000,000</td>
<td>1,250,000</td>
<td>448,300</td>
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<td>5,000,000</td>
<td>2,550,800</td>
</tr>
<tr>
<td>5,000,000</td>
<td>no limit</td>
<td>70%</td>
</tr>
</tbody>
</table>

*Associate Professor, Purdue University, specializing in legal affairs; member of Indiana State Bar Association. Thanks to George Patrick for helpful suggestions.
Table 2. Phase in of fifty percent rate for transfer tax base above $2.5 million: 1982-85

<table>
<thead>
<tr>
<th>Transfer Tax Base</th>
<th>Tax Rate on Excess of Amt. in Col. (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>OF</td>
<td>TO</td>
</tr>
<tr>
<td>-------------------</td>
<td>---------------------------------------</td>
</tr>
<tr>
<td>(1)</td>
<td>Millions (2)</td>
</tr>
<tr>
<td>2.5</td>
<td>3.0</td>
</tr>
<tr>
<td>3.0</td>
<td>3.5</td>
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<tr>
<td>3.5</td>
<td>4.0</td>
</tr>
<tr>
<td>4.0</td>
<td>no limit</td>
</tr>
</tbody>
</table>

Thus, in 1982, the top rate of 65% for gift or estate tax is reached at more than $4.0 million. In 1983, 60% becomes the highest rate on amounts above $3.5 million and by 1985 50% is the highest rate received on tax bases over $2.5 million. While the rates at this level concern very few gift donors or decedent's estates, this is a reversal from the notion of taxing heavier those who appear most able to pay with progressively higher rates.

The unified credit for gifts and estates was part of the unification of estate and gift tax calculations. The credit replaced the lifetime exemption $30,000 for gift making and the specific exemption of $60,000 for an individual's estate. As a tax feature, the idea of a credit is significant since it is subtracted from the tax calculated on the transfer tax base. A credit reduces the tax burden relatively more for a smaller taxable estate than for a larger estate. An increased exemption would give the larger estates a greater dollar savings because its effect would be to remove value from a higher tax rate than the smaller estates.

In 1977 the initial level of the unified credit was $30,000 with scheduled annual increases until a level of $47,000 was reached in 1981. ERTA-81 increased the unified credit in 1982-87 as shown in Table 3.

Table 3. Unified credit from gift and estate taxes

<table>
<thead>
<tr>
<th>Year</th>
<th>Unified Credit</th>
<th>&quot;Equivalent Exemption&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>$47,000</td>
<td>$175,625</td>
</tr>
<tr>
<td>1982</td>
<td>62,800</td>
<td>225,000</td>
</tr>
<tr>
<td>1983</td>
<td>79,300</td>
<td>275,000</td>
</tr>
<tr>
<td>1984</td>
<td>96,300</td>
<td>325,000</td>
</tr>
<tr>
<td>1985</td>
<td>121,800</td>
<td>400,000</td>
</tr>
<tr>
<td>1986</td>
<td>155,800</td>
<td>500,000</td>
</tr>
<tr>
<td>1987</td>
<td>192,800</td>
<td>600,000</td>
</tr>
</tbody>
</table>

A corresponding "equivalent exemption" indicates the amount of transfer tax base that would generate a unified transfer tax equal to the unified credit. The general filing requirement for estate tax purposes is essentially the same as the equivalent exemption. In 1982, a federal estate tax return would not have to be filed, for a decedent's estate if its gross value for estate tax purposes is no greater than $225,000, and if there has been no taxable gifts since 1976. The reason no filing would be required is that even if there were no deductions from the $225,000 estate, the calculated tax on $225,000 would be totally offset by the $62,800 credit.

To understand better the impact of other major changes in estate tax rules, it is helpful to review the components of an estate tax calculation:

1. Gross Estate
2. Deductions (e.g. fees & debts)
3. Adjust Gross Estate (AGE)
4. Marital Deduction (1981 rule is max. of 250,000 or ½ AGE)
5. Adjusted Taxable Gifts after 1976
6. Estate Tax Base
7. Unified Transfer Tax on Base (Table 1)
8. Less Unified Credit (Table 3)
9. Tax Before Other Credits

2. 40,800
In this illustration, the use of the 1981 unified credit of $47,000 leaves a federal estate tax before other credits (line 9) of $40,800. By checking the new schedule of unified credits (Table 3) note that the 1984 credit of $96,300 would surpass the tax of $87,800 (line 7) and result in no federal estate tax due if all other values were the same in the calculation. Of course, the “gross estate” in line 1 may increase in value by 1987 because of appreciation or real growth of net worth making the expanded credit insufficient to prevent estate tax. Also note that if the decedent had no surviving spouse, then the marital deduction (line 4) would be zero and the estate tax base (line 6) would be $600,000. The unified transfer tax on $600,000 is $192,800. Thus, not until 1987 would this much value in an estate tax base (line 6) escape an estate tax.

**THE 100% MARITAL DEDUCTION**

In 1976 the marital deduction was set at the greater of $250,000 or one-half the adjusted gross estate for estate tax purposes. At the same time, the marital deduction for gift tax purposes was set at the first $100,000 fully deductible, no deduction for the 2nd $100,000 and then a 50% deduction for gifts between spouses of more than $200,000.

ETRA-81, in a sense, simplifies the matter by making available a 100% marital deduction for both lifetime gifts and decedent estate transfers. It is effective in 1982. In the above estate tax calculation, availability and use of a marital deduction greater than 50% of the adjusted gross estate would reduce the estate tax base (line 6) and the tax to a point that would let the unified credit go unused. Of course, a 100% marital deduction means that all the net asset values going to the surviving spouse with sufficient rights (essentially such that annual income goes to surviving spouse and leftover assets would be subject to inclusion in that spouse’s estate) which are part of the deceased spouse’s gross estate (line 1) are deductible at line (line 4). If all the assets after other deductions are transferred to the surviving spouse, with sufficient rights the estate tax base (line 6) is zero and the transfer tax (line 7) is zero. Generally, it is not a desirable goal for the unified credit to go unused. What might be preferable would be for the decedent spouse to have arranged for part of the gross estate to go into a trust with limited income rights for the surviving spouse. Such assets would not be part of the surviving spouse’s estate at death. Alternatively, some of the assets might go directly to heirs with or without the use of a trust.

If the full $600,000 in the above example goes to the surviving spouse and that person leaves an estate tax base in 10 years of $1 million due to inflation, savings and other assets, the tentative estate tax is $345,800 less the $192,800 unified credit and results in an estate tax of $153,000. This potential result points up the need for limiting the transfers to the surviving spouse. Also, being eligible for special use valuation of farmland in order to limit the taxable base will be important even in modest estates, at least, at the death of the surviving spouse.

**Transitional Rule for Formula Clause**

While the 100% marital deduction generally applies to estates of post-’81 decedents, a special rule is applicable to certain existing wills or trusts which include a maximum marital deduction formula clause. The purpose of this rule is to retain the definition of maximum marital deduction that existed before ETRA-81 which is “the greater of $250,000 or one-half the adjusted gross estate”. Congress did not want to impose a larger transfer to a decedent’s surviving spouse than they realized would occur by a maximum designation. It could mean more assets going to a surviving spouse than desired and possibly an excessive estate tax on the estate of the surviving spouse.

A 100% marital deduction will not be available for decedents’ estates even though a formula clause mentions the use of the maximum marital deduction as a method of determining how much the surviving spouse should receive where the operative will provision was executed or the trust provision was created before September 12, 1981. The individuals with (maximum) formula clause language in their estate transfer documents are required to re-think this clause along with legal counsel in order to obtain a larger deductible share for surviving spouses. Where the goal is to conserve capital accumulations for children and grandchildren, use of the expanded marital deduction or use of any marital deduction may not be wise for many farm and closely-held business families. Alternatively this special transitional rule provides that a state could pass a law that would permit all “old” formula clauses to be interpreted as referring to the 100% marital deduction.
Under federal estate tax law no terminable property interest would be eligible for the marital deduction. For example, if a decedent spouse left a surviving spouse a life estate in a farm or a similar provision in a trust, the farm's value would be part of the gross estate (line 1) as illustrated above. However, such an arrangement would keep the value of the farm out of the estate of the surviving spouse.

For the marital deduction to be available under the rules through 1981, the surviving spouse must receive at least a general power of appointment over the assets whose value is to be deductible. This means the surviving spouse must be entitled to the income off the assets and have the right to give the assets during life or at death to whomever the surviving spouse desires.

A provision in the '81 Act permits a donor or decedent spouse to provide a terminable interest to the spouse and have the full value of the assets supplying the qualified terminable interest (QTI) property eligible for the 100% gift or estate tax marital deduction if certain conditions are satisfied. For QTI property to qualify for the 100% marital deduction such property must:

1) pass from a decedent or donor spouse
2) provide donee or surviving spouse a qualifying income interest for life, i.e., payable annually or more frequently and
3) not be transferable to any person other than the surviving spouse during the surviving spouse's life.

Further the donor spouse may retain or create powers over the ultimate distribution of the QTI property; they are exercisable only at or after the death of the spouse who enjoyed the "qualifying income interest."

QTI property may be designated (elected) by the personal representative (executor) of an estate. Election of this special arrangement for one's surviving spouse should be planned for in the drafting of wills and trusts since the ultimate tax in the estate of the spouse is an issue. Control of assets during the surviving spouse's lifetime and who ultimately receives the assets is also at stake.

It must be emphasized that QTI property that exists at the death of the spouse who received the QTI will be added to that spouse's estate for estate tax purposes. That is the standard result. If there is marital deduction property at the death of one spouse, the surviving spouse receiving such property will have this property or its appreciated value in his/her gross estate for estate tax purposes, and it will also be subject to the Indiana inheritance tax. If the QTI recipient wishes to make a lifetime gift of a QTI, then it is subject to gift tax. Also this new law places the liability for the added estate or gift tax due to QTI property upon the person(s) receiving the QTI property or QTI in the case of a gift. If this rule is followed, the recipient(s) of the QTI property will have this property taxed at the highest rates reached by the spouse's gift or decedent spouse's estate tax base.

Another special rule provides that if an individual creates a qualified, charitable remainder annuity trust or unitrust, and the only noncharitable beneficiaries are the donor and/or spouse, the marital deduction will be available for the income interest (annuity or unitrust) received by the donee or surviving spouse and a charitable deduction will be allowed for the remainder interest going to charity. Until 1982, the terminable interest which the spouse receives does not qualify for the gift or estate tax marital deduction.

The long standing rule is that the full value of jointly owned property was part of the gross estate for federal estate tax purposes unless the surviving joint tenant could prove contribution or consideration furnished. The Internal Revenue Service placed the burden of proof upon the surviving joint tenant which was viewed as a difficult task by most lawyers representing farm widows. Several items of proof might be available, depending upon the situation, such as:

1) personal income, inheritance and gifts contributed to the acquisition of joint property,
2) property interests that were gifted or devised in a joint form of ownership,
3) services performed directly in the production of income in a family business and
4) under the legal notion that half of the "landlord's share" of income from tenancy-by-the-entirety property belongs to each spouse regardless who was responsible for acquiring the entireties property in the first instance.

Several Tax Court cases supported these principles on behalf of widows. One of the most famous litigants being Mrs. Otte from Seymour, Indiana who convinced the Tax Court that one-half of all the value of the jointly-held farmland and half the value of other farm assets and inventories was entitled to be excluded from Mr. Otte's federal estate tax return.

But many surviving spouses did not have as persuasive a case and impressive record of contribution as Mrs. Otte and could not convince the IRS nor the Tax Court if they chose to litigate. Even though the surviving spouse would benefit from the estate tax marital deduction of $250,000 or 50% of the adjusted gross estate, this general presumption of lack of contribution toward what was viewed as "partnership" property or "theirs together" came under persistent political attack. Since full title to the property vested in the surviving (joint tenant) spouse, this was only a question of impact of the estate tax. The "fractional interest" rule added by TRA-76 legislation and the "two-percent" rule added by the Revenue Act of 1978 were attempts to solve this problem which apparently did not gain public acceptance.

Starting on January 1, 1982 only one-half the value of marital joint property must be or is allowed to be included in the gross estate of the deceased spouse. Of course, the one-half that is included in the estate tax return of the deceased spouse avoids the estate tax since the value would be included in the marital deduction.

The "two percent rule," which was a set of rules to allow a surviving spouse to receive "2% credit" toward the equity in joint property for each year of material participation up to 50% of the value of the asset, now becomes redundant and was repealed.

Under the new rules in 1982, when a spouse obtains joint tenant status without a contribution equivalent to the value of the interest he receives, this will be a gift. However, the new 100% marital deduction precludes the occurrence of a taxable gift.

The "fractional interest" rule is a provision allowing half value of joint property to be excluded from a decedent spouse's estate tax return if a gift was declared on the interest a spouse had received without having contributed. With the new "50% rule" for inclusion of value of marital joint property in a deceased spouse's estate and the 100% marital deduction for gift tax purposes, the "fractional interest" rule became a redundant provision and was repealed.

In reality, the exclusion of 50% of the value of joint property from the deceased spouse's estate prevents a step-up in the income tax basis of this half which is a major consideration for both depreciable and nondepreciable capital assets. Since the adjusted basis of a depreciable asset available generates annual income tax deductions, the prevention of a step-up in adjusted basis to the value of estate tax purposes or fair market value at death is a major tax gain for the United States Treasury. In the case of nondepreciable capital, such as farmland, the lower the basis the more capital gain at time of sale and the more income subject to tax. Thus, the most significant aspect of the exclusion of 50% of marital joint property from the decedent spouse's federal estate tax return is one of generating income tax in subsequent years. Even if the entire value of the joint property were included for estate tax purposes, it would all qualify for 100% marital deduction. Thus keeping half the joint property out for estate tax purposes does not reduce estate tax.

The significant use of joint-ownership by spouses with modest or substantial capital estates remains a very questionable practice. Joint tenancy or tenancy-by-the-entireties means right of survivorship or full title in the surviving spouse although subject to debt where it attaches to joint interests. Thus, full value passes to the survivor and creates a possible estate tax problem for the surviving spouse. Even modest sums can accumulate to high value estates as a result of several years of inflation.

If the property produces significant income the survivor may experience high annual income tax liabilities. This situation might be avoided by transferring property to a trust with a discretionary income rule or by transferring the property directly to the benefit of children and grandchildren in lower income tax brackets.
Another problem that may arise where a surviving spouse receives substantial capital, whether by right of survivorship or testamentary devises, is the responsibility of management and control of the business capital: real estate, farm machinery, livestock and inventories. Frequently children are frustrated with these problems and the presence of gross inequities because of parental bias or favoritism. In fact, remarriage may occur, and assets derived from the labor of children of a first marriage may ultimately be transferred to a subsequent spouse. While children obtain certain interests where the law of descent operates, there is no law that says children must receive anything from their parents' estate.

EXEMPTION FOR VOLUNTARY CONTRIBUTIONS TO QUALIFIED RETIREMENT PLANS

For many years the qualified corporate retirement plan enjoyed a unique tax advantage. The tax deductible employer contributions and associated earnings which accumulated tax exempt were, under most circumstances, exempt from gift and estate tax as retirement plans or annuity contracts. Starting in 1982, even funds accumulated from voluntary employee contributions into qualified plans will also be excludible from the decedent's gross estate. This new provision for an exclusion from the estate tax has a new counterpart which allows an income tax deduction for an individual for up to $2,000 of voluntary employee contributions to qualified retirement plans.

An estate exemption for voluntary contributions is consistent with similar exemptions for individual retirement accounts (IRA's) and HR-10 or Keogh Plans, which were added to the estate tax rules in recent years. All of these tax incentive measures are aimed at encouraging individuals to establish significant personal retirement assets in order to supplement Social Security benefits.

The income tax deductibility of voluntary contributions and their estate tax exempt status may be attractive to farm corporations with qualified retirement plans. However, the high capital needs and high expected earning rates of additional capital within well managed farm operations may continue to limit use of retirement plans unless the plan funds are available to the business. Further, individual employees, since 1974, may establish IRA's which their employer may elect to encourage and support. IRA's may now be maintained along with qualified employer plans.

SPECIAL USE VALUATION OF FARMLAND REVISED

The assets in which a decedent has an interest at death must be valued at fair market value at date of death as they are included in the gross estate for federal estate tax purposes. This general rule has two exceptions or alternate valuation rules.

First, there are alternate valuation dates available for all the assets in an estate which may be up to 6 months after date of death. This permits valuation of assets as they are sold, exchanged or distributed within the 6-month period. The assets still in the estate at the end of the 6-month period may be valued as of that last day of the period. This alternate valuation date approach may be a wise election when the assets are, in total, falling in value.

A limited alternate valuation tool, special use valuation, was added to the federal estate tax rules with TRA-76 and became effective for decedents’ estates on January 1, 1977.

While this rule was formulated in somewhat broader terms than special valuation for certain farmland, it is apparent from the requirements and workings of this alternate valuation approach that it was intended to lessen the estate tax on farmland in the estates of active family farms.

To be eligible for special use (farmland) valuation a decedent’s estate and past activities must satisfy numerous requirements. The decedent must have been a resident or citizen of the United States, and 50% of the adjusted value (fair market value at death less debts on the assets) of the estate must be assets used in a business (e.g., farming), and 25% of the adjusted value of the estate must be real estate.

Further, the real property must pass from the decedent to a qualified heir. There are essentially two use or involvement tests that must have been satisfied by the decedent or a family member. First, the decedent or decedent’s family member (after ERTA-81) must have been “at risk” (income depending upon a share of the production) at time of death and 5 or more of the last 8 years the decedent lived. In addition, the decedent or a family member must have been materially participating 5 or more of the last 8 years the decedent lived.
“Farm Method” Valuation Formula

A formula for calculating special use valuation is included directly in the use valuation rules which is:

\[
\frac{5\text{- year average of net cash rents from farmland with comparable soils}}{\text{Divided by} \quad 5\text{- year average of the average annual interest rate on all new Federal Land Bank (FLB) loans}}
\]

This formula is a simple capitalization approach to obtaining the value of a parcel of land based on an estimate of income from the land. “Net cash” rents refer to “arms length” cash rents less land taxes on the specific land which must be obtained from landlords and tenants on land comparable to that land in the decedent’s estate for estate tax purposes and in the “locality” of the land in the estate. The “5 years,” refers to the 5 full years prior to the year of the decedent’s death. The appropriate Federal Land Bank interest rate for this purpose is calculated by the IRS and published annually as a revenue ruling by FLB Districts. For the Louisville District, which includes Indiana, these rates for decedents of the respective years are: 1977—8.64%; 1978—8.80%; 1979—8.88%; 1980—9.21% and 1981—9.53%.

Actual results from decedents’ estates in Indiana for the years 1977-79 indicate that the “farm method” special valuation results in values for estate tax purposes of about 50% of the fair market value. However, the total estate value could be reduced below fair market value by no more than $500,000 under the original legislation.

Table 4. Federal estate tax before and after special use valuation for selected adjusted gross estates without a marital deduction: 80 percent held as farmland and use valued at 50 percent of fair market value for 1981 and 1987*

<table>
<thead>
<tr>
<th>Adjusted Gross Estate</th>
<th>FEDERAL ESTATE TAX</th>
</tr>
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<tr>
<td>250,000</td>
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<tr>
<td>1,000,000</td>
<td>600,000</td>
</tr>
<tr>
<td>1,500,000</td>
<td>900,000</td>
</tr>
<tr>
<td>2,000,000</td>
<td>1,400,000</td>
</tr>
<tr>
<td>2,500,000</td>
<td>1,900,000</td>
</tr>
</tbody>
</table>

*Results are based upon the unified credit of $47,000 for 1981 and $192,800 for 1987. No reduction is taken for the Federal State Death Tax Credit since that amount or more will be collected by virtually all states’ inheritance or “pick-up” tax when the estate tax exceeds other credits.

**The reduction below fair market value is limited to $600,000 in 1981 and $750,000 after 1982.

Table 4 indicates the potential of special use valuation for estate tax reduction according to the rules in 1981 when there is no marital deduction. The 1981 results reflect the expanded special use valuation reduction limit of $600,000. The 1987 results reflect a reduction limit of $750,000 and the enlarged unified credit of $192,800.

Amendments to Special Use Valuation

Several amendments to the special use valuation rules were added by ERTA-81. Congress adopted many suggestions intended to make this estate tax saver workable for thousands of farmland owning families. These changes include:

Value Reduction Limits

1. Increases in the amount that special use valuation may reduce the qualified real property below the fair market value to $600,000 for 1981; $700,000 for 1982 and $750,000 for 1983 and thereafter. This adjustment is to correct for appreciation in property values that have taken place since 1976 and that are expected in the future.

Woodland is Real Estate

2. Qualified woodlands are now eligible to be treated as real estate for special valuation. Qualified woodlands are identifiable areas of real property for which business records are maintained and the property is being used for growing and harvesting timber.

A recapture tax will be imposed when the qualified heir severs or disposes of the timber during the recapture period. The amount of the recapture will be determined from the lesser of: 1) amount realized on disposition of the timber (or fair market value if not an
arm’s-length sale) or 2) the amount of the recapture tax that would have been imposed on disposition of the heir’s entire interest in the qualified timber.

Allowing certain timber or qualified woodlands to count toward special use valuation assets may permit certain estates to reach the 50% and 25% tests mentioned above. It is doubtful that the farmland method of valuation will be useful for timber. There is an alternate special use valuation using a multiple factors approach (including comparable sales, expected income capitalization, assessed land values, capitalization of rental income) which may provide a lower valuation for timber than the fair market value.

3. Share rents (gross receipts less cash operating expenses) starting for decedents’ estates in 1982 may be used in lieu of cash rent data where share rent but no cash rent comparables are available. This added feature should help insure the availability of the farm method of valuation in localities where cash rentals are not common or not available to the estate needing the data.

4. The material participation requirements may be suspended for a decedent who:
   a) was retired under Social Security rules at death or
   b) disabled at death as long as the 5 out of 8 year participation rule was satisfied at the date of retirement under Social Security or date of disability.

A decedent’s estate will not be ineligible for special valuation for failing to have materially participated during a period of retirement or disability where it is continuous through date of death, so long as the 5 out of 8 year material participation requirement was satisfied on the date the retirement or disability began. In the typical family farm situation, the retired farmer would be relieved by a child or in-law and the material participation requirement would be satisfied by the family member. If the farmer becomes disabled at an age before children are capable of participating, then this new rule may be of help.

In some family farm situations, the prospective qualified heirs or other family members are not available to operate or engage in a materially participating lease on their parents farmland.

However, the heirs may wish to take advantage of special use valuation. It must be remembered that the qualified heir(s) must be engaged in a farm business (“at risk”) and they or their family member also satisfy a material participation requirement during a recapture period following the decedent’s death. The recapture period, for a decedent’s estate electing special use valuation where the decedent died before 1982, is 15 years.

5. In regard to material participation, there is a special rule for surviving spouses to help relax this requirement. If a decedent leaves qualified real property which passes to a decedent’s surviving spouse, “active management” of the farm or other business shall be treated as material participation by the surviving spouse in the leasing and operation of the farm.

Active management is defined as “making business decisions” other than the daily operating decisions of a farm. An important statement in a House Report says “various combinations of which constitute active management are inspecting growing crops, reviewing and approving annual crop plans in advance of planting, making a substantial number of the management decisions of the business operation and approving expenditures for other than nominal operating expenses in advance of the time the amounts are expended.” The Report goes on to say: “Examples of management decisions are decisions such as what crops to plant or how many cattle to raise, what fields to leave fallow, where and when to market crops . . . . how to finance business operations and what capital expenditures the trade or business should make.” Clearly, such involvement on the part of a landowner is similar to what is required for material participation status. Obviously “active management” contemplates frequent visits to the farm as material participation requires. The above statement suggests the “active manager” could disapprove or veto various major management decisions since “approval” is apparently required. Material participation status requires that veto power be in the material participant or else there is procedure for arbitration if the participant doesn’t have the “last word.” The House Committee statement does make clear that the income derived from active management will not be considered as self employment income and thus not subject to self-employment (social security) tax. Another distinction is that a family member of the
surviving spouse is not permitted to satisfy the “active management” requirement, but a family member may satisfy the material participation requirement for which active management is a substitute. Thus, it appears that the distinction may be only one of labelling the nature of a surviving spouse’s activity in a share lease involving qualified real property.

A statement and illustration in a House Report explains that the period of material participation of a decedent spouse who left qualified property to a surviving spouse may be added (tacked) to the surviving spouse’s term of active management (or presumably a surviving spouse’s material participation). This might be necessary to satisfy the 5 out of 8 years test for the surviving spouse who does not live 5 years beyond the death of the decedent spouse. While the amendment to the Internal Revenue Code does not clearly state tacking will be permitted, some tax writers believe this result was intended and others simply presume adding of decedent participation and surviving spouse’s active management is part of the amended law. The new amendment allowing the surviving spouse to take up the “active management” status on what is qualified real property says that the first decedent’s estate need not actually elect special use valuation, but only be eligible to do so to permit active management in place of material participation.

Active Management and Leasing Implications

The “active participation” rule permits surviving spouses to keep land eligible for special use valuation by being in an “active management” role, but not paying social security tax (nor losing social security benefits, presumably, by virtue of earned income although nowhere is this directly stated). This special rule for the surviving spouse would be most important where there is no family member farming the farmland which could constitute material participation on behalf of the surviving spouse, in which case, the surviving spouse need not actively manage. But note that the surviving spouse, as a qualified heir, would still have a requirement to be “at risk” — meaning a share lease rather than a cash rental — in order to satisfy the qualified use test on the qualified real property from the deceased spouse. While on other farmland that the surviving spouse may own, the at risk or qualified use test may be satisfied by a family member according to the new provision discussed above. Surviving spouses could utilize share leases on some land and cash rent other land and have all the land eligible for special valuation in estates. However, the cash rental would probably make that land ineligible for the “4%-15 year installment” plan for financing estate tax according to IRS rulings at this time.

10 Year Recapture Period

6. Estates electing use valuation for pre-1982 decedents have a 5 year phase-out period at a monthly reduction in the recapture liability from the 10th to the end of the 15th year. The potential recapture is reduced by one-sixtieth as each month passes until the 60th month has elapsed. Beginning in 1982, the period during which the savings in estate tax due to special valuation is subject to recapture is reduced to 10 years. During the 10 years, the recapture will be for the full amount of the estate tax savings on the portion of the specially valued land subject to the recapture provision. It should be noted that if a qualified heir dies during the recapture period, his share of the liability for recapture and the associated lien on the property is dismissed.

Likekind Exchanges and Involuntary Conversions Permitted

7. More flexibility was added to the special valuation rules where likekind exchanges and involuntary conversions occur. If replacement property was required under either of these special tax rules within 5 years of death, it was not permitted to satisfy the 5 out of 8 year test for purposes of the ownership, qualified use, and material participation requirements. ERTA adds a provision to permit the time periods during which pre-death ownership, qualified use, and material participation requirements were satisfied for the real property exchanged or converted to be added to the time periods during which these three time requirements were satisfied for the replacement property. The replacement property must be used for the same qualified use as the replacement property. Tacking is permitted for replacement property only up to the value of the replaced property on the date of disposition.

This provision increases the availability of special use valuation to more estates since involuntary conversions occur frequently under the power of eminent domain. Also likekind exchanges of land occasionallly provide flexibility with little or no income tax.
8. Since the policy behind special use valuation is one of reducing the estate tax for family farms, the definition of a family member is important. Special use valuation requires that:
   a. Only real property that passes to qualified heirs (who are family members of the decedent) is eligible.
   b. Pre-death ownership, qualified use and material participation requirements must be satisfied by the decedent or a member of the decedent’s family.
   c. The post-death material participation requirement must be satisfied by participation of the qualified heir or a member of the heir’s family.
   d. Property can be disposed of during the recapture period without imposition of a recapture tax (essentially the estate tax savings from special use valuation) only if the transfer is to a member of the qualified heir’s family.

Until the end of 1981, a family member of an individual includes:
   a. spouse
   b. ancestors
   c. lineal descendants
   d. lineal descendants of grandparents and
   e. spouses of those in categories (c) and (d).

For the estates of decedents dying after 1981, a family member of an individual includes:
   a. spouse
   b. ancestors
   c. lineal descendants; of the individual, of the individual’s spouse and of the individual’s parents
   d. the spouse of any individual in category (c).

The new definition of family member excludes lineal descendants of the individual’s grandparents and adds lineal descendants of individual’s spouse. Note that lineal descendants of the individual’s parents which were retained are part of the broader category of lineal descendants of grandparents which was dropped.

From a planning point of view, if one is relying on aunts, uncles, first cousins (or their spouses) to satisfy material participation requirements, adjustments in leasing arrangements may be desirable where possible. Adjustments in wills or trusts may be desirable if the special use valuation would be jeopardized. It is not clear why Congress removed those lineal descendants from the family member definition other than a view that aunts and uncles and first cousins were too remote among relatives to benefit from a special tax provision for family farms.

It should be kept in mind that a decedent’s family member may not be a qualified heir’s family member. For example, a decedent’s nephew is not a family member and as an operating tenant could have satisfied the material participation requirement for a decedent, but the decedent’s nephew is not a family member of the decedent’s surviving spouse and daughter who might be the qualified heirs. In order to avoid recapture, the surviving spouse or daughter would have to materially participate with the decedent’s nephew as tenant or some other tenant or lease to a tenant who is a family member of the surviving spouse or daughter such as the daughter’s husband.

The following five amendments (items 9-13) to the special use valuation rules are retroactive to January 1, 1977. Where an estate may be able to benefit from special use valuation as a result of the retroactive provisions listed below, ERTA-81 provides a 6-month period following the date of enactment (Aug. 13, 1981) of ERTA during which IRS will permit reinstatement of a special valuation election. Reinstatement would be permitted even though the 3-year statute of limitation may have elapsed.

9. Up until the amendment in ERTA-81, property purchased from the decedent’s estate by a qualified heir or if subject to an option to purchase held by or devised to a qualified heir was passing by purchase rather than bequest, devise or inheritance could not be specially valued. The revised rule comes with several aspects, the main being that a qualified heir does not make farmland ineligible for special use valuation when it is purchased from the estate or a trust including a purchase under an option right or land that is subject to unexercised option rights held by a qualified heir.

Five Provisions in ERTA-81 are Retroactive

Purchases from Estates Permitted
When the estate or trust sells to a qualified heir, the gain recognized, if any, is measured by the amount the sale price exceeds the fair market value on the date of the decedent's death or alternate valuation date but without regard to the special use valuation.

However, the heirs' basis for the farmland purchased from the decedent's estate or trust is set at the special use valuation for the land, but increased by gain recognized by the estate or trust.

Also, if the provision for an option to buy sets the price at a value below fair market value, for example, at the special use valuation, the consenting to the special use valuation election by other qualified heirs does not constitute a gift to the heir benefitting from the option.

Addition of this flexibility to the special use valuation rules is important since the first option to buy in one or more qualified heirs is a useful element of well rounded estate transfer plans. Such options are often limited to one child (usually the farmer) in a family, but the option could provide equal opportunity for each child to buy the other's interest or interest of a surviving parent. The price need not be a bargain price. In fact, a bargain price is generally unfair to the other heirs. Also, the option need not be exercised at all or complete. The heir(s) who has the option right might better utilize limited equity to acquire non-family resources such as a neighbor's land or other needed capital assets.

Nevertheless, the existence of rules for controlling the rights of any interest that an heir or a family member of an heir who wishes to sell for whatever reason is a vital part of a transfer plan for closely held or family farm operations. Rules are needed to smooth the transfer from the party who demands to be bought out to the family member(s) who wishes to gain control of any interest for sale. Restriction of transfer rights like a minority interest in a business will tend to reduce the market value of an interest, making such interest less valuable for gift and estate tax purposes. It should be recognized that even though restrictions on rights to transfer are important, they do tend to bias downward the value of a gift or inheritance of an heir which is a negative aspect of such plans. It must be kept in mind that a farmland estate or a business is vulnerable to an unhappy heir. If such an heir or family-member is left, for example a tenant in common interest, he can force a market sale of the entire parcel of land as the result of a partition suit. In modern estate planning, restrictive transfer arrangements are built into corporations, partnerships and business or land trusts to control the transfer of the various interests. However, restrictive transfer agreements can be provided for without a complex business or asset holding arrangement. Restrictions and options can be included in special contracts and deeds as well as in wills and testamentary or lifetime trusts.

10. By authority of a July 1980 Treasury Regulation, the qualified use requirement was stated to require that a decedent's land could be eligible for special use valuation only if the decedent personally was "at risk" (had an equity interest) in the farm operation. This was interpreted to mean that the landowner's annual income had to be dependent upon annual production. Thus, in general, a share lease was required. A cash rental arrangement would disqualify the farmland from special use valuation. Further, this qualified use requirement had to be satisfied at least 5 out of 8 years before the decedent's death and at the date of death. An implication of this regulation was that a decedent who was cash renting to a family member would leave the land ineligible. This would be true even though the family member was satisfying the material participation requirement for the decedent. What was made clear (after three and one-half years of the special valuation law) by the July 1980 Regulation was that the qualified use ("at risk") requirement and the material participation requirements were two distinct requirements. Qualified heirs also are subject to the "at risk" requirement as well as the material participation requirement. As we will see below, the material participation requirement has been relaxed in several situations.

ERTA-81 amends the "at risk" rule in only two situations. First, it is now permissible for a family member to have (or to do so in the future) satisfied the "at risk" requirement for a decedent. A family member's business use (at risk or active versus passive involvement) can be attributed to the decedent. Thus, a landowner could cash rent to a son or other family member and leave land eligible for use valuation, if other requirements were satisfied. Of course, cash rental to a nonfamily member would be a failure of the at risk
requirement. While a family member may satisfy the qualified use requirement for a decedent, the same does not hold true for a qualified heir nor an "eligible" qualified heir as we will describe below. The active management substitute for material participation does not amend the qualified use requirement calling for an active leasing arrangement.

One useful lesson that was reinforced by the need for an active rather than a passive leasing arrangement to satisfy the qualified use requirement, is that an active or share lease need not be a material participation lease. A landowner may have a share lease that does not contain the authority over farm management decisions that a material participation lease requires. The material participation lease generates earned income for the landowner which is subject to social security tax and which could bring a reduction in social security benefits if the lessee is not yet age 72.

To illustrate, a qualified heir could have nonmaterially participating share lease with a family member tenant and avoid recapture of the estate tax savings arising from special use valuation. The family member tenant would satisfy the material participation requirement for the qualified heir.

Qualified Heirs Have Two Year "Grace Period" for "At Risk" Requirement

11. The second amendment to the qualified use or at risk requirement provides a two year grace period starting at the decedent’s death during which a qualified heir may fail to use the qualified real property in the qualified use ("at risk" farming arrangement) but not cause the recapture tax to be imposed.

This is a very helpful provision since the strict interpretation of the qualified use requirement allows for no lapse of the "at risk" status on the part of a qualified heir. And while a family member could satisfy the "at risk" requirement for a decedent, a family member of the qualified heir is not permitted to fulfill this requirement for the qualified heir.

Neither qualified heirs nor the personal representative may have the legal power to terminate a cash lease arranged by the deceased lessor. Also while a family member of the decedent may satisfy the "at risk" requirement for the decedent, no comparable provision permits this for a qualified heir(s). A family member of qualified heirs can participate on their behalf, but the heirs must personally be party to an at risk (shares) lease. The lease could be a non-materially participating share lease if a qualified heir(s) or a qualified heir’s family member(s) are participating in some manner, such as being the tenant. Also, the qualified heir(s) may not learn of the requirements to be "at risk" until some considerable time after the death of a decedent. Trust, partnership or corporate interests will permit qualification where the appropriate lease is utilized if the entity is a lessor rather than operating as a tenant and a qualified heir(s) or family member(s) is a trustee or an employee in order to satisfy the participation requirement.

Eligible Qualified Heirs May Active Manage

12. ERTA-81 extends the "active management" standard in place of material participation to three other classes of eligible qualified heirs besides the surviving spouse already discussed above. An eligible qualified heir includes:

1) the decedent’s surviving spouse,
2) a qualified heir who is not yet age 21,
3) a disabled qualified heir, and
4) a qualified heir who is a full time student as defined for income tax personal exemption deduction purposes.

In the case of eligible qualified heirs who are minors or disabled, categories (2) and (3), the active management may be performed by a fiduciary (a guardian or trustee, but not an agent). The allowance for the fiduciary to perform the active management is a practical if not an essential need since the minor or the disabled may not have the knowledge nor legal capacity to manage. Of course, the surviving spouse of a decedent and a disabled heir could maintain this status indefinitely. But it should be noted that, for trust planning, the surviving spouse (unless categorized as disabled) cannot benefit from the provision allowing a trustee to fulfill the active management requirement.

Again from the information available at this time, the only apparent difference between active management and material participation is that no self employment (social security) tax will be assessed on net earnings for active management as it is for material participation. Regulations indicate that an agreement must be established between landowner and tenant establishing a material participation status. Typically a share lease would include the appropriate clause(s) to establish the "agreement" to provide the landowner with participation authority for major crop and livestock production and
marketing decisions. But a lease that contemplates active management surely must provide the qualified heir-lessee with the authority to participate in the decision-making which active management requires. Of course, the material participation may be satisfied for a qualified heir(s) by a family member while this is not permitted in the case of the active management substitute. But a family member might serve as a guardian or trustee for an eligible qualified heir who is a minor or disabled and in that situation satisfy the active management requirement. However, as the regulations and law develops the requirements for achieving material participation status may be more strict than the law and actual practice has been up to now.

13. ERTA-81 provides that otherwise qualified property passing into a discretionary trust in which no beneficiary has a present interest can be eligible for special use valuation as long as all the potential beneficiaries of the trust are qualified heirs. A discretionary trust arises when the trustee has the discretion to determine the amount of income or principal to be received by an individual beneficiary. Those beneficiaries who receive income or principal from a trust under a discretionary rule do not have a present interest according to a rule in the Internal Revenue Regulations, but instead have a future interest.

The IRS, under their authority to issue regulations concerning special use valuation where trusts were holding title to the otherwise qualified property, previously had established a rule that if the qualified heirs do not have a present interest as trust beneficiaries then the property establishing the trust principal is ineligible for special use valuation.

The new retroactive amendment now permits both modern trust and income tax planning and special use valuation.

Besides the retroactive amendments and eight other changes discussed above, a few other changes concerning special use valuation remain to be mentioned which are effective for decedent estates after 1981.

14. To understand the following amendment, the tax characteristic of an asset referred to as adjusted basis or simply basis, must be understood. Basis arises or is set in a number of ways and is adjusted by certain economic or tax transactions. For example, if a farmer pays $500 for an acre of land, the basis of that acre is $500. If it is sold for $1,500, the gain for income tax purposes is determined by subtracting the basis, $500, from $1,500, the sale price. If a farmer or landowner spends $10,000 for field tile or drainage, the $10,000 amount is the basis of the tile and is depreciable or subject to the accelerated cost recovery system added by ERTA-81. Each year the original basis of $10,000 would be adjusted downward as a portion of the basis provides a deduction for income tax purposes.

When a person dies owning capital assets such as land which is subject to federal estate tax, the basis of the land is set or stepped-up to the value allowed for federal estate tax purposes — fair market value, alternate value or special use value. No gain is taxed or loss allowed as the basis is adjusted for the capital assets in an estate. Until the end of 1981, if a qualified heir causes recapture (by selling the qualified real property outside the qualified heirs or their family members or ceasing to satisfy the “at risk” active management or material participation requirements) within the 15 year recapture period (10 years for decedents’ estates electing special valuation after 1981) there would be no step-up in basis allowed. That is, the recapture event would cause the estate tax savings (a pro rata share if only part of the qualified property is subject to recapture) made possible by special use valuation to be paid to the IRS. Under the law prevailing through 1981, no adjustment is made to the qualified heir's basis which was set at the special use value for the qualified real property even though the imposition of the additional estate tax means the property is taxed essentially at the fair market value as of the decedent’s date of death.

With an amendment in ERTA-81, a qualified heir can make an irrevocable election to increase the income tax basis of the qualified property subject to recapture (additional estate) tax. The increase in basis is to the fair market value of property (or alternate value if that were elected) at date of decedent’s death. If the heir elects the basis adjustment, he must pay interest on the amount of the recapture tax over the period extended from nine months after the decedent’s death until the due date of the recapture tax. Interest will be computed at the rate(s) charged on deficiencies of tax for the period involved.
The increase in basis in the qualified heir’s property is deemed to have occurred just
before the recapture event. No retroactive changes in depreciation, or other deductions
or credits, would be made to reflect the increased basis, but if there is a recapture tax
under other sections of the tax law because of the disposition of the property, the
increased basis is used in determining gain or loss on the disposition. This amended
provision is available for recapture events arising from several use valuations for dece-
dents who die after 1981.

15. Lastly, in regard to the election for special use valuation, the ’81 Act permits an
election on a late estate tax return as long as it is the first estate tax return. Prior to 1982, if
the election was not made on a timely Form 706 (either 9 months after death or with an
IRS approved extension in time) it was not permitted.

A special section (6166) in the Internal Revenue Code was added (effective January 1,
1977) which permits estates with a significant “closely held” business interests to defer
payment of some of the estate tax. Interest on the estate tax deferrable (up to $345,800
less the unified credit) is only 4 percent. Further, only interest is required to be paid for up
to 5 years after death and then the interest and principal is due in no more than 10 annual
principal payments. No demonstration of a hardship or lack of liquidity is required for
eligibility.

A threshold test for eligibility of the “4%-15 year” plan is that 65 percent or more of the
adjusted gross estate (gross estate minus certain allowable deductions) must be made up
of one or more closely held business interests. After 1981, the 65% requirement is reduced
to 35% by ERTA. Interests in various closely held businesses may be added together
(aggregated) to reach the necessary proportion of the estate.

For the purpose of aggregating to satisfy the 35% rule, an interest in a closely held
business (besides solely-owned assets in a proprietorship) includes an interest in:

1. A partnership interest where there were no more than 15 partners or a corporation
having no more than 15 shareholders or

2. A partnership or corporation where at least 20 percent of the capital interest, or at least
20 percent of the voting stock, respectively, is includable in the decedent’s gross estate.

Also,

1. Stock in a qualified closely held business interest must not be readily tradable and
most importantly

2. A spouse’s and family member’s interest will be considered held by the decedent in
order to meet the above 20% test. These family members include brothers, sisters,
grandparents, children and grandchildren.

There is a lien in the amount of the deferred tax liability plus the total interest that would
be payable on it. The lien attaches only to the real property in the amount of the deferred
taxes plus the aggregate amount of the interest for the first four years of the deferral
period. The deferred tax debt is subject to acceleration when there is a sufficiently large
disposition or withdrawal of the closely held business interest.

ERTA also included the following provision to amend the rules relating to the use of the
“4%-15 year” plan:

1. Portions of an interest representing less than 50% of the value of the decedent’s interest
in a closely held business may be disposed of and/or withdrawn before payment of the
unpaid balance will be accelerated. This rule applies to transfers after 1981.

2. The death of an heir of the closely held business interest does not bring about an
acceleration of the debt as long as the transferee is a family member of the transferor.
Here family member includes spouse, lineal descendants, ancestors, brothers and sisters
(whether by whole or half blood).

3. The late payment of interest and principal will not cause an acceleration of the debt as
long as such is not six months or more overdue.

Another major concern for qualifying for the “4%-15 year” plan is whether the decedent
was actually engaged in a business as an individual such as a farmer or other operator or
employee of a closely held business. The question arises when a decedent may because of

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retirement appear to simply own an investment. Rulings a few years ago indicated that a cash rental relationship to a business would not be "running a business." A materially participating landowner would be interpreted as running a business. It would appear that a share lease without material participation, in the case of farming, might be sufficient to attain the classification of being engaged in a business. Some tax writers suggest that material participation may be a requirement. Can a family member have satisfied the business involvement requirement for a decedent landowner?

A pair of IRS private letter rulings held that the following could be classified as interests in a closely held business:

1. Decedent's son-in-law managed for 28 years prior to the decedent's death with the decedent providing a share of inputs for a share of production.

2. Decedent share leased, but the decedent's sister was actually supervising management of the farm in what appeared to be an "active" or materially participating manner.

While conclusions for general application are not the purpose of private rulings (they are answers for specific fact situations), it would appear that a nonparticipating share lease may be a sufficient involvement to satisfy the requirement for being engaged in a business, but the law is not clear.

The law also provided a 10 year installment plan for estate tax, recently at 12% interest on the unpaid balance, requiring a closely held business interest of 35% of the gross estate or 50% of the taxable estate. ERISA repealed this provision on January 1, 1982.

Keep in mind that the "4%-15 year" plan covers only the estate tax associated with $1 million in closely held business assets. Prior to 1982 both the "4%-15 year" plan and the "10 year" plan could be used together for closely held business interests that exceed $1 million. After 1981, only the 4%-15 year plan remains in the law.

A special tax law permits the redemption of certain closely held stock for the purpose of paying federal estate and state death taxes (plus interest) and funeral and administration expenses. Redemption (payout of corporate cash for its stock) for this purpose, to the extent there is gain (price minus basis on stock redeemed) it is treated as capital gain. Generally, such a distribution by the corporate treasury is considered a dividend in federal tax law, and the payout would be treated as ordinary income for income tax purposes. Only 40% of the capital gain is added to gross income for income tax purposes. Thus, for handling certain costs in an estate settlement, a person held liable for some or all of these costs has a means of getting cash out of the closely held corporation with the capital gains preference.

ERTA introduced a few amendments to this "303-redemption" section in order to keep its provisions consistent with the 4%-15 year installment plan discussed above. Where an estate involves closely held stock, both the redemption plan and the 4%-15 year installment plan might be used together.

To be eligible for the "303-redemption" the decedent's estate must be composed of closely held stock in the amount of 35% of the adjusted gross estate after 1981. The test is 50% through 1981. For purposes of aggregating the ownership of two or more corporations to meet the 35% test, the decedent must have in his estate 20% or more of the outstanding stock of each corporation whose stock is to be aggregated to meet the 35% test. Prior to 1982, the requirement for aggregation is 75% of the outstanding stock of each corporation.

The 20% requirement for aggregation is also part of the provisions for the 4%-15 year installment plan in order to permit aggregation to meet the 35% test.

Also for the purposes of the 20% test for aggregation of closely-held stock interests, a decedent's surviving spouse's share of community property stock is counted. ERTA also permits a surviving spouse's stock held with decedent as joint tenants, tenants-by-the-entirety and tenants in common to be aggregated with the decedent spouse's. These changes in the provisions of "303-redemptions" makes this special law much more accessible to decedent stockholders' estates and makes it more consistent with modern estate planning which often involves wives and children holding a significant proportion of stock, in a closely held family business. With inflation in asset values, the estate tax
may remain a significant problem even where the elder family member’s holdings have been reduced. Also, the “303-redemption” can be a “polite” way to greatly reduce or eliminate the stock holdings of certain family members which may facilitate management and control of a business.

The Tax Reform Act of 1976 added a provision that if property in an estate passed with sufficient rights from deceased parent to a child under age 21 and this individual had no known parent surviving and the current decedent parent had no surviving spouse then a deduction amounting to $5,000 times the number of years the decedent’s child was under age 21 was provided. This “orphan’s deduction” is repealed by ERTA effective for decedents’ estates where the decedent’s death occurs after 1981.

TRA-76 added a new tax to the estate to be imposed when a beneficiary dies with a life interest (or an income beneficiary for a fixed period of years) received from a grantor or settlor of an older generation and the life interest or entire interest passes to a generation younger than the deceased beneficiary. The tax is calculated by adding the value of the generation skipping trust or other device to the estate of the deceased beneficiary and determining the added amount of estate tax.

This additional tax is paid out of the funds of the generation-skipping transfer and not out of property that is in the estate of the deceased beneficiary. Transfers to beneficiaries who are grandchildren of the settlor or grantor where the generation-skipped is that of a child (grandchild’s parent) are excludable to the extent of $250,000 per child.

Generally, the generation-skipping tax will apply to taxable distributions and terminations that occur after June 11, 1976. It will not apply in cases of transfers under irrevocable trusts in existence on January 1, 1983. ERTA added the 1983 date as a year extension to this transitional rule.

The tax rates, the unified credit and the marital deduction described above are all applicable to lifetime gifts. ERTA-81 included several other changes related to gift making all of which are effective for transaction after 1981.

Of more interest to individuals than any other single change is the increase of the annual exclusion from $3,000 to $10,000. The annual exclusion is available on a calendar year basis to as many donees as the donor can justify or afford. Under the gift-splitting rules, a husband and wife could each give one or the others assets in the amount of $10,000 within their respective annual exclusions for a total of $20,000 per donee. If a couple have their separate assets or money to gift, they can gift $20,000 together to a given donee per year, but no gift-splitting would be involved. For the annual exclusion from the gift tax to apply, the interest given must be of a present interest rather than a future interest.

A future interest is an interest that is limited so as to begin in use, possession or enjoyment at some future date or time. Essentially the reverse is a present interest, that is, the unrestricted right to the immediate use, possession or enjoyment of property or the income from property. In planning gifts of stock, trust or partnership interest or conveyances of interests that may be subject to certain restrictions, it is important to have skilled legal assistance so that a gift is not provided in too restrictive a manner. If it is, the IRS might rule the gift is not a present interest, but a future interest, causing the annual exclusion(s) to be disallowed. Where stock and other intangible, personal property capital interests are gifted, it is important that annual income rights and the right to dispose of the interest are provided in order to achieve a present interest classification.

Gifts that are validly includible within the annual exclusion to an individual donee for a calendar year do not require the filing of a gift tax return. Thus the $10,000 annual exclusion will reduce the number of gift tax returns that IRS will have to process. But note that if a husband and wife utilize the gift splitting law, both spouses must file returns even though the annual exclusion has not been exceeded. The reason filing is necessary with gift-splitting is that each spouse must sign the others return to show the use of their annual exclusion for the specific donee(s) and report to the IRS why no adjusted taxable gift resulted.

Gift making activity is not limited to the amount of the annual exclusion. In fact, until the unified credit is utilized, an individual may make adjusted taxable gifts up to the “exemption equivalency” of the unified credit which is $175,625 in 1981 and increasing to $600,000 by 1987. Gifts to one’s spouse are 100% deductible.
Gift tax rules may best be understood by a simple illustration.

1. Total gift — fair market value on date of gift January 1, 1982 $110,000
2. Less: Annual Exclusion (after 1981) per donee 10,000
3. Adjusted Taxable Gift 100,000

Plus — Prior Taxable Gifts
4. Pre-1977 100,000
5. Post-1976 (1981 Gift) 50,000
6. Total Prior Taxable Gifts 150,000
7. Tentative Gift Tax Base 250,000
8. Tentative Gift Tax (See Table 1 — Unified Rates) 70,800

Less — Credit for Tax on Prior Taxable Gifts
9. Pre-1977 (From the Table 1 — Unified Rates) 23,800
10. 1981 Adjusted Taxable Gift Tax —0-
11. Total Credit for Prior Gift Tax 23,800 (23,800)
12. Less Unified Credit in 1982 (Table 3) (62,800)
13. Tax Due on January 1, 1982 Gift —0-

These calculations reflect many rules or assumptions. First, gifts are valued by law for gift taxes at the fair market value as of the date of the gift. The law of federal gift taxes requires all prior taxable gifts (line 6) to be added to the current adjusted taxable gift (line 3). In this illustration, it is assumed there was one or more pre-1977 taxable gifts amounting to $100,000 and a 1981 adjusted taxable gift of $50,000. The result is the tax base (line 7) of $250,000 and the tax is $70,800 (line 8) from the unified schedule of rates. (Table 1). A credit is allowed for prior gift taxes and the law requires the credit for the pre-1977 gifts to be calculated from the unified rates, Table 1, even though the pre-1977 gifts taxes were calculated from a different schedule of rates which was repealed at the end of 1976. The unified credit at the time of the 1981 gift was $47,000 (see Table 3) explaining why there was no gift tax liability in 1981. The unified credit in 1982 is $62,800 leaving a tax liability of zero (line 13).

This illustration shows the capacity for gifts within the rules without a gift tax liability. But note that the adjusted taxable gifts after 1976, ($150,000 after January 1, 1982) will be added to the individuals estate tax base after death forcing the individuals estate value into the highest bracket possible in Table 1. But at death the full unified credit is available which by 1987 is $192,800 (Table 3).

Of course, the individual will utilize as many donees as is practical in order to maximize the number of $10,000 annual exclusions and thereby avoid or minimize adjusted taxable gift values which will be added back into the individual's final transfer tax calculation, on a federal estate tax return. Likewise, we can now see the advantage for married individuals to engage in gift-splitting in order to get as much value within annual exclusions as possible, and each spouse has a unified credit to utilize for high-valued gift programs to help avoid a current gift tax liability. Where long term plans and multiple donees are practical, the best advantage can be taken of the $10,000 annual exclusion by avoiding an adjusted taxable gift. Generally, spouses should avoid gift-splitting by gifting from their personal assets rather than from assets of their spouses.

Due Dates for Gift Tax Returns

Starting in 1982 gift tax returns are due on an annual basis on the standard filing date for calendar year taxpayers, April 15. Gift tax return filing dates can be automatically extended if an extension is granted for filing the income tax return. But this does not extend the time for paying the gift tax due unless a special extension is granted showing undue hardship. If a person dies during the year of a gift which requires a gift tax return, the gift tax return must be filed no later than the due date of the estate tax return (including extensions in filing time granted).

Since 1970, and through 1981 there has been a quarterly filing requirement for gift tax returns. For 1981 gifts, a gift tax return is due at the middle of the quarter following the quarter in which the adjusted taxable gifts for the year reached $25,000, but if this sum is not reached until the 4th quarter or if there are taxable gifts but less than $25,000, the return is due on April 15.
Exemptions for Qualified Transfers: Medical and Education

ERTA-81 adds an unlimited exclusion from gift tax for amounts paid for an individual’s medical expenses or school tuition when such transfers satisfy the “qualified transfer” requirements. Generally, qualified transfers for medical expenses are those paid to an individual or institution for a wide range of medical care including transportation costs. School tuition is excluded if paid to an educational organization which normally maintains a regular faculty curriculum and student body at a place where educational activities are regularly carried on. Qualified transfers need not be included in a gift tax return since they are exempt by law.

The House Report on this provision points out that payments to reimburse a donee-individual do not qualify. The payments must be made to the person or organization providing the service. Qualified transfers do not cover educational expenses in general, but are limited to direct tuition costs paid directly to the qualifying educational organization.

The purpose of this new provision is to relieve individuals who make “qualified transfers” as described above to assist individuals for whom they are not legally obligated, to assist as a husband or parent is obliged toward a spouse or minor child. Where there is a legal obligation to provide, at least to the extent of what would be the custom for the station in society of the individuals involved, there is no gift classification for such provisions. Medical assistance or tuition provided an adult child by a parent or by a grandparent to grandchildren may be held to be a gift. If the amounts were above the annual exclusion, then a taxable gift would arise. One tax writer has pointed out that if a person such as a grandparent pays for what is declared a qualified transfer and the beneficiary has a parent with a legal obligation under local law to make such a payment, the parent may be deemed under income tax law to realize income to the extent the parent is assisted in their legal obligation. If the law is administered in this manner, the donor-grandparent could utilize the $10,000 per donee annual exclusion to avoid gift tax making transfers to grandchildren and both parents permitting a $30,000 per year total annual exclusion. If grandmother can join in gift making, the total annual exclusion could reach $60,000. In many cases the “qualified transfer” exclusion would not be needed to achieve substantial transfers without incurring a gift tax liability or even an adjusted taxable gift.

Gifts Within 3 Years of Death

ERTA-81 provides that for decedents dying after 1981, gifts made within 3 years of death except for limited situations, will not be included in the decedent’s gross estate for federal estate tax purposes. For most all gifts, this removes the appreciation (if any) in the value of the gift from date of the gift to date of death. As explained above, the new rule initiated in 1977 makes all adjusted taxable gifts part of the estate tax base, but the adjusted taxable gift values are determined as of the date of the gift. The rule through 1981 is to include gifts made within 3 years of death in the gross estate at the fair market value at death if a gift tax return was required at the time of the gift. Also, since 1976 it is and will continue to be the law that gift tax paid within 3 years of death must be added to the gross estate. This new within 3 years of death rule is intended to apply to pre-1982 gifts of decedents who die after 1981.

Certain categories of gifts are exceptions to the new 3-year rule and will still be included in the decedent’s gross estate. They are:

1. transfers which entail a recent life estate,
2. revocable transfers,
3. transfers taking effect at death,
4. powers of appointment and
5. life insurance proceeds.

All of these property interests come under the general heading of items that would have been included in the gross estate (although each may contain limited property rights) if the decedent had retained them. Transferring them within 3 years of death will not avoid inclusion in the gross estate. It should be emphasized that the very common asset, life insurance, is in the insured’s gross estate if the decedent insured retained any “incidents of ownership.” And as is noted by (5) above if a decedent has transferred all the “incidents of ownership” within 3 years of death, the proceeds of the policy are still in the decedent’s gross estate for federal estate tax purposes.

While certain gifts within 3 years of death may be excluded from the gross estate, after 1981, in so far as determining the gross estate for calculating the estate tax, these transfers
will be included in the gross estate for certain percentage tests to ascertain qualifications for:
1. Code Section 303 or redemption of stock to pay death taxes,
2. Code Section 2032A for special valuation of farmland,
3. Code Section 6166 for the extension of time to pay estate taxes where the estate consists largely of an interest in a closely-held business and
4. determination of property subject to estate tax liens.

This special variation in the new 3-year rule is designed to allow the special tax benefits of items (1), (2) and (3) if the estate can otherwise qualify. However, those gifts within the $10,000 annual exclusion, but within 3 years of death will not get this special treatment.

There is a special variation in the “3-years before death” rule on gifts between spouses. Since gifts between spouses, after 1981, are 100% within the marital deduction, all gifts between spouses avoid the need for a gift tax return. Thus, such gifts should avoid coming under the 3-year rule. But a special provision says, in effect, for the purpose of determining whether a deceased spouse’s estate qualifies for the special advantages of: Section 303, stock redemption, Section 2032A, special use valuation of farmland, and Section 6166, deferral of estate tax, mentioned above, the value of gifts within 3 years of death from the decedent spouse to the surviving spouse will be included in the decedent spouse’s estate. This measure is designed to prevent the “unloading” of assets which would prevent qualification for the beneficial tax measures.

**Transitional rule for powers of appointment tied to annual exclusion**

A transitional rule concerning the applicability of the increased annual exclusion was included in ERTA. Certain trust arrangements include powers of appointment which are in terms of the gift tax annual exclusion, $3,000. The new Act provides that the increased gift tax annual exclusion, $10,000, will not apply to powers granted under a trust created before the 30 days after the date of the Act’s enactment (August 13, 1981) and not amended on or after the 30 days after the date of the Act’s enactment.

This transitional rule applies if: (1) the power is exercisable after 1981, (2) the power is defined in terms of the Code Sec. 2503(b) exclusion, and (3) there is no state law construing the power of appointment as referring to the increased annual exclusion.

**Basis of property gifted within one year of donee’s death and received back by donor.**

The income tax basis aspects of capital assets are important in tax and estate planning. In the case of a lifetime gift, the basis of the gift in the hands of the donee is the donor’s basis at the time of the gift plus an increment of any gift tax paid on the gift or allocable to the gift. The increment is determined by multiplying any gift tax paid by the proportion of the appreciation (fair market value less basis) in the gift to the fair market value of the gift at the date of the gift. But property that is part of the gross estate for estate tax purposes receives a basis (step-up) equal to the value of the property in the estate (fair market value, alternate value or special use value).

An ERTA provision prevents this step-up in basis as property goes through an estate if the decedent had received the property from the heir or devisee of the property within one year of death. Apparently, individuals would “use the death” of the donee to obtain an increase in basis on an asset that they anticipated would be returned to the donor by a will provision or other transfer arrangement or law of descent. When such an event takes place, the new law, effective for gifts after 1981, says that the “donor-heir” will receive the basis the asset had at the time of death of the donee. Further, this rule provides that if the donor receives proceeds back from an asset gifted to the donee-decedent because of a sale in the estate and distribution, the basis will still be restricted to what it was just before decedent’s death. Also, if the “donor-heir” only receives a part of the gift asset(s) or proceeds from the gift, then the basis on the proportion received will be restricted.

The lower basis in the hands of the heir will mean greater capital gains upon a subsequent sale or less depreciation in the future if the asset is one that is depreciable.

**Gifts to charitable or tax-exempt organizations**

Gifts to organizations or institutions that are recognized as tax-exempt by the United States Treasury, are generally exempt from the gift tax by way of a charitable deduction (as well as being fully deductible from the estate tax). If property is transferred in part to a tax-exempt organization or institution with part of the interest retained by the donor or transferred to a noncharitable entity, this arrangement must be done in the form of a
Charitable remainder annuity, unitrust or pooled income fund in order to permit a charitable deduction for the value of the interest passing to the tax-exempt organization.

In this area of planning prior to 1982, if an original work of art were to be donated, but a related copyright retained or transferred to a noncharitable donee, no charitable or estate tax deduction was available. An ERTA provision will permit charitable and estate tax deductions for transfer of a work of art to a tax-exempt organization while the copyright is retained or transferred to a noncharity.

Above it is indicated that voluntary contributions to qualified retirement plans up to $2,000 a year will be income tax deductible after 1981. In addition, the accumulations of such contributions, like the other deductible accumulations of qualified retirement plans, can also be exempt from the estate tax and the gift tax. That is, the designation of a surviving beneficiary who will receive an annuity or payment attributable to deductible employee contributions is exempt from gift tax.

The idea of a qualified disclaimer is one of rejecting a gift or testamentary transfer in a timely way with the effect of another (or others) receiving what they would have received if the disclaimant had predeceased the decedent leaving the property. A qualified disclaimer lets the property pass without being subject to gift tax nor will it be in the disclaimant’s estate. It is just as if they had never received it. Qualified disclaimers must be in writing within 9 months of the transfer of the interest of the disclaimant (or 9 months after the disclaimant’s 21st birthday). Such a strategy can prevent an heir from accumulating an excess estate leading to unnecessary gift or estate tax and it may mean less income tax for the disclaimant.

Actually the qualified disclaimer as it was placed in the law in 1977 required that the disclaimer be valid under state law. Certain kinds of disclaimer situations were not part of the state laws such as disclaimer of an intestacy share. ERTA permits a disclaimer to be valid so as to avoid gift tax as long as the party(s) received the disclaimed property that would receive the property if the disclaimer were valid in a given state.

For example, intestacy laws may provide for a decedent’s widow(er) to take all if there are no children — only half if there is a child surviving. In fact a disclaimer of an intestate share (arising when decedent had no will) may not be provided for by state law. If an adult child disclaims in favor of a surviving parent following the death of the other parent, the parent receiving the property would be the one who would have received the property had there been no child or had the child predeceased the surviving spouse.

In the more likely case of taking under a will, if a person disclaims a devise under a will, the disclaimed interest will pass to the individual(s) who takes under the will in the alternative. Thus, it is important for a will to be drafted in such a way that if an intended heir or beneficiary wishes to elect not to receive some or all of a devise, individuals acceptable to the decedent and the disclaimant stand to take in the place of the disclaimant. A qualified disclaimer is not permitted where the disclaimant elects someone to take in the alternative who would not have received the interest if the disclaimant had predeceased the alternate taker. In that case, the transfer would be subject to the federal gift and estate tax.
References


Note: Additional papers and publications are available on various tax legal topics, estate management and business organization from: Gerald A. Harrison, Agr. Econ. Dept., Purdue University, 630 Krannert Bldg., West Lafayette, IN 47907.

Other Publications*

EC-521 Estate and Financial Record for Estate Planning
EC-519 Indiana Laws for Understanding your Estate: Planning and Probate

*Available through your county Extension office or the AGAD Building mail room, Purdue University, West Lafayette, Indiana 47907.