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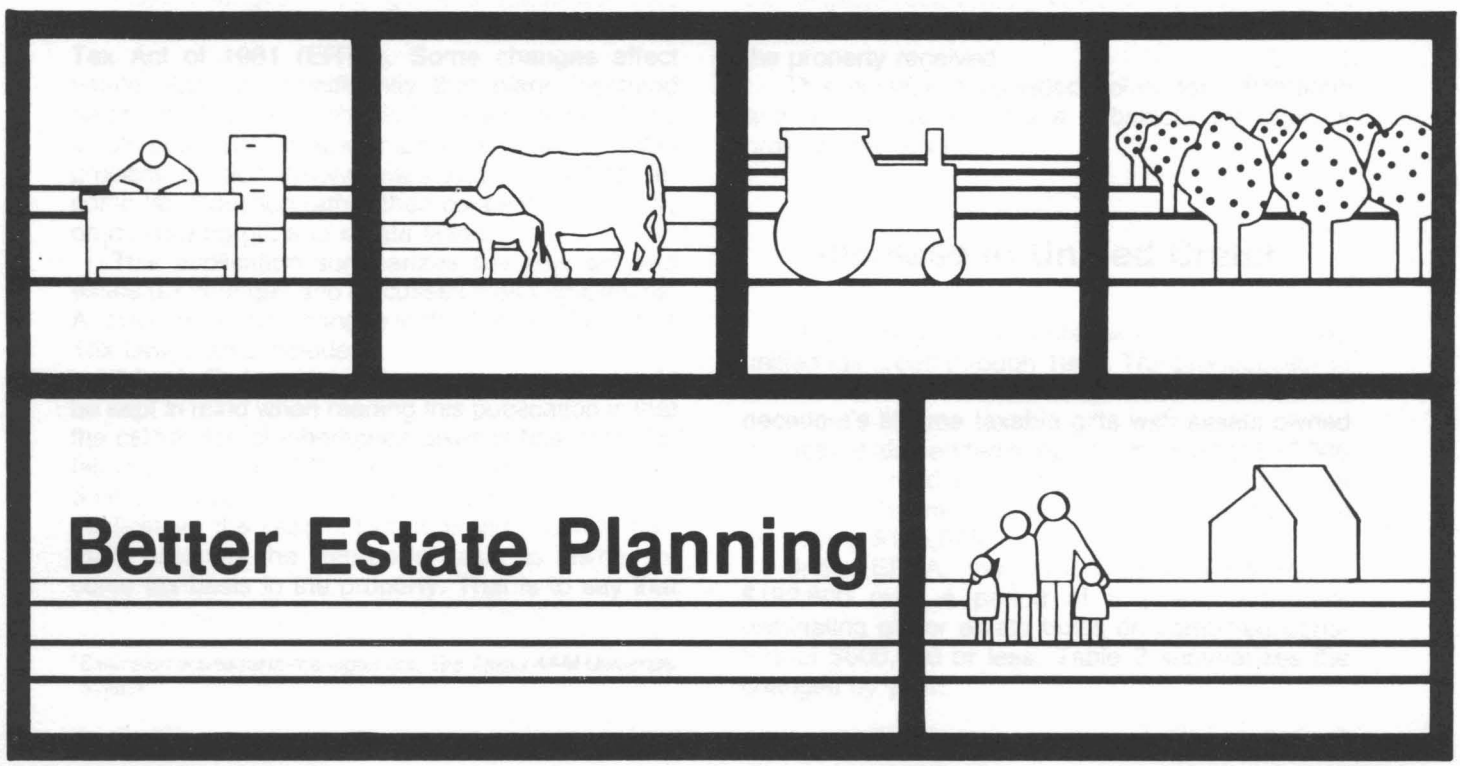
The Economic Recovery Tax Act of 1981



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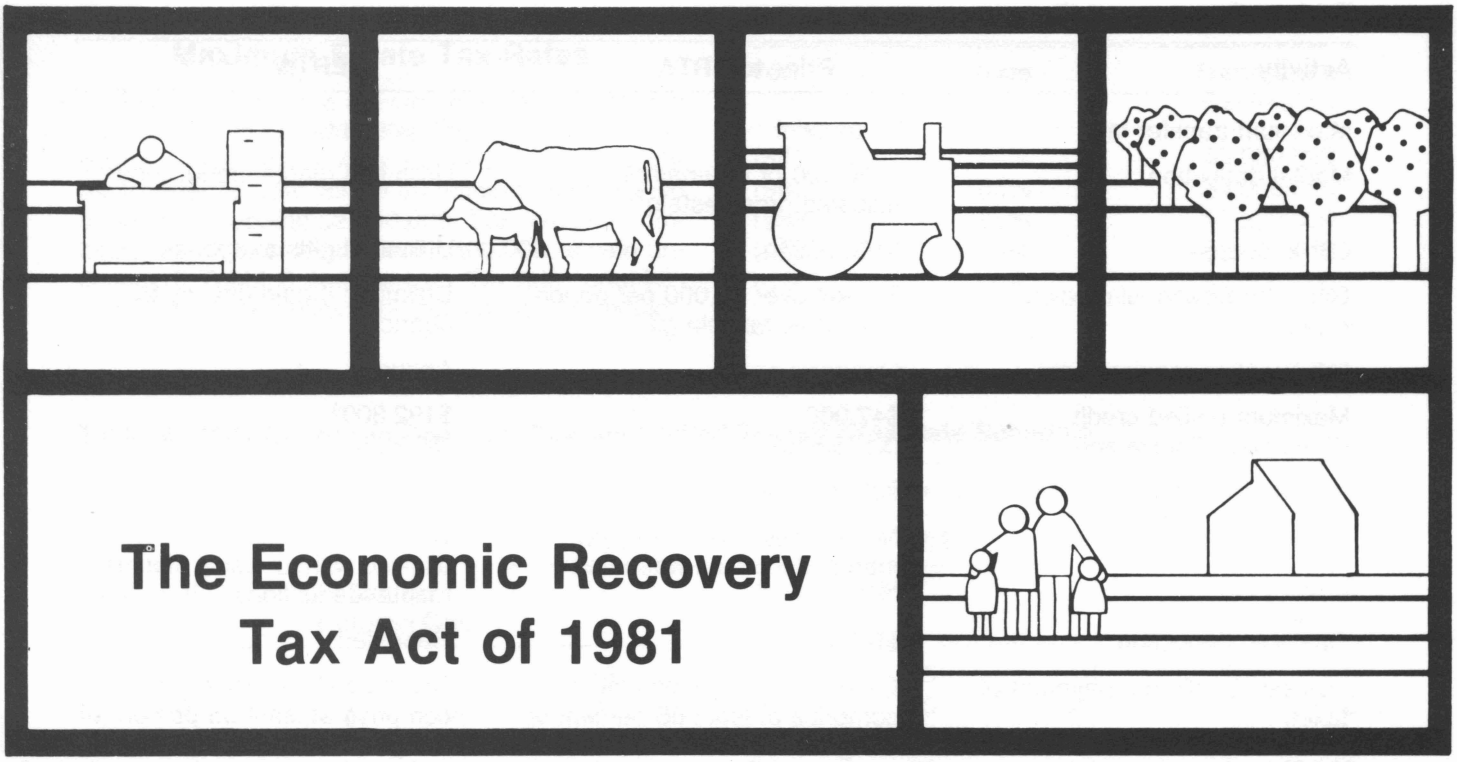

The Economic Recovery Tax Act of 1981

*Jose G. Pena, Ashley C. Lovell and Robert H. Kensing**

Major changes in the gift and estate tax laws were implemented under the Economic Recovery Tax Act of 1981 (ERTA). Some changes affect estate plans so significantly that plans instituted before this legislation should be re-evaluated. Some estate plans should now emphasize more equitable property division among heirs and subsequent income tax reduction rather than concentrating solely on minimizing gift and estate taxes.

This publication summarizes the new gift and estate tax changes and discusses their implications. A review of recent changes in the Texas Inheritance Tax Law is also included.

A basic Federal estate tax concept which should be kept in mind when reading this publication is that the calculation of inheritance taxes is based on the fair market value (FMV) of the estate at the time of death. Except for some exceptions discussed in this publication, the recipient of inherited property normally assumes the step-up in basis as his/her income tax basis in the property. That is to say that the recipient receives the value of the property used for estate tax purposes as the income tax basis of the property received.

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Increase in Unified Credit

ERTA will gradually increase the gift and estate unified tax credit through 1987. The predecessor to ERTA, the Tax Reform Act of 1976, combined the decedent's lifetime taxable gifts with assets owned at death. It also added a maximum credit of $47,000 which prevented imposing gift or estate taxes on combined lifetime gifts and transfers at death not exceeding $175,625.

Under ERTA, the unified credit increases to $192,800 over a period of 6 years, eventually eliminating gift or estate taxes on combined transfers of $600,000 or less. Table 2 summarizes the changes by year.

**Extension economists-management, The Texas A&M University System.*

Table 1. Summary of Changes

Activity	Prior to ERTA	ERTA
Maximum transfer tax	70 percent	50 percent[1]
Marital deduction	$250,000 or one-half of adjusted gross estate[2]	Unlimited marital deductions
Gift to spouse	$100,000[3]	Unlimited gifts to spouse
Gifts of educational/medical expenses	Excess over $3,000 per donee treated as taxable gift	Unlimited if paid directly to agency
Gift tax filing requirements	Quarterly	Annually
Maximum unified credit (Exemption Equivalent)	$47,000 ($175,625)	$192,800[4] ($600,000)
Annual gift exclusion	$3,000/donee	$10,000/donee[5]
Retained life estates	Not allowed unless lifetime marital deduction was used	Certain terminable interest allowed without using lifetime marital deductions
Orphans' deduction	$5,000	Repealed
15-year installment payment of taxes	Closely-held business must comprise at least 65 percent of the gross estate	Closely-held business must comprise at least 35 percent of the gross estate
Gifts within three years of death	Includable in estate at FMV at date of death or alternate valuation date	Not included except transfers: a. with retained life estate b. effective at death c. with revocable provisions d. which constitute proceeds of life insurance e. with retained powers of appointment

[1]Phased in during 1982 to 1985.

[2]Adjusted gross estate is the total value of the estate minus debts, death expenses and administrative costs.

[3]See section covering unlimited marital deduction for additional details.

[4]Phased in during 1982 to 1987.

[5]The donor's cost basis is transferred to donee, but the $10,000 limit is based on Fair Market Value (FMV) of the gift.

Table 2. Unified Tax Credit

For Decedents Dying in	Unified Tax Credit	Equivalent Exemption	Community Property Equivalent Exemption
1981	$ 47,000	$175,625	$ 351,250
1982	$ 62,800	$225,000	$ 450,000
1983	$ 79,300	$275,000	$ 550,000
1984	$ 96,300	$325,000	$ 650,000
1985	$121,800	$400,000	$ 800,000
1986	$155,800	$500,000	$1,000,000
1987 and later	$192,800	$600,000	$1,200,000

Note: Taxable gifts made prior to 1985 are added to the estate at the tax rate schedule effective in the year of death.

Decrease in the Maximum Estate Tax Rates

ERTA reduces the maximum gift and estate tax rate from 70 to 50 percent in 5 percent increments over a 4-year period. After this reduction, the highest transfer tax rate will be 50 percent on combined transfers exceeding $2,500,000. Tax rates for combined transfers of less than $2,500,000 remain unchanged. Table 3 summarizes the rate reduction and Table 4 the unified transfer tax rate schedule.

Table 3. Maximum Transfer Tax Rate

Year	Rate	Transfers in Excess of:
1981	70%	$5,000,000
1982	65%	$4,000,000
1983	60%	$3,500,000
1984	55%	$3,000,000
1985+	50%	$2,500,000

Table 4. 1981 Economic Recovery Tax Act Unified Transfer Tax Rate Schedule

		Unified Transfer Tax Rate Schedule				
		1982	1983	1984	1985	
Value of Estate	Tax on Column One	Plus Percent				On Excess Over
$ 0	$ 0	18	18	18	18	$ 0
$ 10,000	$ 1,800	20	20	20	20	$ 10,000
$ 20,000	$ 3,800	22	22	22	22	$ 20,000
$ 40,000	$ 8,200	24	24	24	24	$ 40,000
$ 60,000	$ 13,000	26	26	26	26	$ 60,000
$ 80,000	$ 18,200	28	28	28	28	$ 80,000
$ 100,000	$ 23,800	30	30	30	30	$ 100,000
$ 150,000	$ 38,800	32	32	32	32	$ 150,000
$ 250,000	$ 70,800	34	34	34	34	$ 250,000
$ 500,000	$ 155,800	37	37	37	37	$ 500,000
$ 750,000	$ 248,300	39	39	39	39	$ 750,000
$1,000,000	$ 345,800	41	41	41	41	$1,000,000
$1,250,000	$ 448,300	43	43	43	43	$1,250,000
$1,500,000	$ 555,800	45	45	45	45	$1,500,000
$2,000,000	$ 780,800	49	49	49	49	$2,000,000
$2,500,000	$1,025,800	53	53	53	50	$2,500,000
$3,000,000	$1,290,800	57	57	55	50	$3,000,000
$3,500,000	$1,575,800	61	60	55	50	$3,500,000
$4,000,000	$1,880,800	65	60	55	50	$4,000,000

Unlimited Marital Deduction

The marital deduction is the amount by which the gross value of an estate may be reduced when calculating estate tax liability. The new law removes all limits on the marital deduction for both gift and estate tax purposes. As long as the property passes to the decedent's spouse, its value at the time of the decedent's death is 100 percent deductible if death occurred or gifts were made after December 31, 1981. However, the surviving spouse must assume the donor's income tax basis in the property.

Under the previous law, the deduction for gifts of separate property between spouses was limited to the first $100,000 plus one-half the value exceeding $200,000. The deduction for transfers to a spouse at death was limited to the greater of $250,000 or one-half the value of the decedent's estate after deducting debts, administrative costs and funeral expenses. Under the new law, all inter-spousal transfers, regardless of value, are exempt from federal gift and estate taxes.

In addition, ERTA allows a spouse more control over money or property left to the surviving spouse.

To qualify for the estate tax marital deduction, property interests must be deductible "terminable" interests. In the past, property passing to a spouse in absolute ownership qualified for the marital deduction, but an ordinary life estate did not. Under ERTA, the unlimited marital deduction may be used to defer taxes on property left in trust for the benefit of the surviving spouse with the remainder going to other benefactors. "Qualified terminable interest property" (QTIP) is property transferred between spouses in which the recipient has a qualifying income interest for life. Therefore, transfers of terminable interests are considered qualified terminable interests if the decedent's executor (executrix) or in the case of a gift, the donor, declares them a legal life estate or a life income interest in a trust and the surviving spouse receives the qualifying income interest for life. Therefore, a spouse can put his or her estate into a trust for the surviving spouse; when the surviving spouse dies, the remainder of the trust goes to the grantor's children. This agreement, normally called a "QTIP" trust, prevents benefits from passing to spouses of second marriages.

Certain conditions qualify a "QTIP" trust for the new unlimited marital deduction. First, the surviving spouse must be entitled to all income from the entire estate left in trust, or all income from a specific part of the estate (which is treated as a separate interest), payable annually or, more frequently, for the surviving spouse's lifetime. As a result, income interests for a term of years, or life estates which terminate on remarriage or some other specified event, will not qualify. Second, no one can give away any part of the principal or income producing property to anyone other than to the surviving spouse. However, a testamentary power exercisable only after the surviving spouse's death is allowed.

Therefore, a trustee may invade the principal of the trust for the benefit of the surviving spouse, but if a beneficiary spouse transfers any of the trust property, during life, the full value of the property will be subject to the federal gift tax at that time. If the surviving spouse retains the interest until death full value of the remaining property will be included in his/her estate. Therefore, this provision does not eliminate the death tax on the property but defers it until gifted or until the surviving spouse's death. The estate of the surviving spouse, however, may recover any estate taxes due on this property from the person or persons receiving the property.

Another important consideration under the rules authorizing the unlimited marital deduction is the transitional provision. This provision includes wills and trusts containing a formula marital deduction clause expressly providing that the surviving spouse is to receive the "maximum" marital deduction. Under the transitional rule, "maximum" means maximum under the pre-1982 law and not maximum under the law applicable to deaths after 1981 if:

1) The marital deduction clause was not amended within 30 days after the date the 1981 legislation became law,
2) The decedent dies after 1981, and
3) The state does not move to define "maximum" by statute as maximum under ERTA.

Therefore, if a will qualifies for the transitional rule, it should be changed if a greater (or lesser) marital deduction is desired than would qualify under the pre-1982 law. For wills that do not qualify for the transitional rule, the will should be amended if the marital deduction clause will produce an unsatisfactory result in the size of marital deduction.

Increase in Annual Gift Tax Exclusion

Beginning in 1982, ERTA increases the annual gift tax exclusion to $10,000 per recipient. Under the old law it was $3,000 per recipient. Under the new law, if a married couple agrees to make a joint gift, they can give up to $20,000 per recipient each year without incurring any gift tax. When planning gifts, it is advisable that the property having the greatest potential for appreciation be gifted to exclude its subsequent increase in value from the donor's estate.

In addition, ERTA provides an unlimited exclusion for medical expense and school tuition gifts, provided payments are made directly to the medical or educational institution.

If all gifts made in a calendar year are within the annual exclusions, no federal gift tax return is required for that year. Therefore, lifetime gift exclusions under ERTA have been greatly liberalized. Beginning in 1982, a married couple could pay any amount of tuition and medical expenses for each child (or any other person) and give an additional $20,000 to each individual before a federal gift tax return is required.

Elimination of "Gifts in Contemplation of Death"

Under the old law, gifts made by a decedent within 3 years of death were taxed at their value on the date of death, not on the date of the gift. Under ERTA, taxable gifts made within 3 years of death will be taxed at their value on the date of the gift if the gift is made without any constraints or conditions. Therefore, gifts with retained life estates, gifts that take effect at death, gifts which are revocable, gifts with retained powers of appointment and gifts of the proceeds of life insurance continue to be taxed under the former 3-year rule.

Other Changes

Tax Basis of Property Received within One Year of Death

Under the old law, the recipient's beginning basis in property received from a decedent was generally its fair market value at the date of death or 6 months thereafter. Because of this increase in basis, a person could make a gift to someone who was about to die and then arrange to have the property transferred back to the donor in the donee-decedent's will. The original owner would get the stepped-up basis in the property and escape much, if not all, of the income tax due on a subsequent sale.

Beginning in 1982, the new law prohibits the stepped-up basis on property given to the decedent by gift within one year of death and returned either directly or indirectly to the original donor or donor's spouse after the decedent's death.

New Disclaimer Rules

Intended recipients of inherited property may refuse to accept it, that is, disclaim it. The property then passes to someone else, but it could be treated as a transfer by the disclaimant for tax purposes. However, if the disclaimer is "qualified," the property interest is treated as a direct transfer from the original transferor to the recipient.

Prior law provided that a qualified recipient of inherited property could refuse to accept the property and the property would be treated as though it went directly from the original donor to the person who was legally entitled to receive the property. The catch was that a disclaimer was qualified only if: (1) the original recipient could legally refuse to accept the property under local law, and (2) the property passed without any direction from the person(s) disclaiming it.

Disclaimer rules under ERTA eliminate any reliance on the local laws. Now, a refusal to accept property that fails to qualify for a disclaimer under local laws will still pass the property interest for Federal estate purposes if:

1) The disclaimant does not direct where the property goes,
2) The refusal allows a timely transfer of the property interest to the person(s) entitled to receive it under local laws, and
3) The refusal satisfies other Federal transfer requirements. Federal requirements generally state that a written transfer of an entire interest in the property be treated as a qualified disclaimer if:
   a) A written disclaimer is received by the transferor (or legal representative) within 9 months after the later of:
      1) The date of the transfer, or
      2) The date the disclaimant reaches 21.
   b) The disclaimant has not accepted the interest or any of its benefits, and
   c) The ultimate transfer is to a person or persons who would have received the property had a qualified disclaimer been made.

Under ERTA, the local Laws of Descent and Distribution determine who is a valid recipient of inherited property, but they will no longer determine the validity of a disclaimer.

Filing Gift Tax Returns

Under the prior law, gift tax returns were filed quarterly. Under ERTA, gift tax returns must be filed and gift tax paid annually (if the unified credit has been depleted). The return for the preceding calendar year is due by April 15. If the donor dies, the gift tax return is not due until the Federal estate tax return is filed (including extensions).

Repeal of Orphans' Exclusion

Prior law allowed a deduction for bequests to the decedent's surviving minor children. The new law eliminates the deduction.

Delay in the Imposition of New Generation-Skipping Tax

ERTA defers operation of the generation-skipping transfer tax until January 1, 1983, and retains $250,000 maximum non-taxable generation-skipping transfer per child.

Technical Changes in Special Use Valuation Provisions

The Tax Reform Act of 1976 and the 1978 amendment allowed real property used in a farm or other closely-held business in a decedent's gross estate to be valued at less than its fair market value.

Basically, real property may be valued for estate tax purposes on the basis of its use rather than its fair market value if:

1) The decedent is a citizen of the U.S. and the property is in the U.S.,
2) It is devoted to farming or other closely-held business,
3) The farm or closely-held business' personal and real property is at least 50 percent of the adjusted value of the gross estate (gross estate less allowable unpaid indebtedness attributable to the property in question at fair market value),
4) Twenty-five percent of the adjusted value of the gross estate (at FMV) must be real property,

5) The property passes to decedent's family or qualified heirs,

6) Each heir signs the original request for "use" valuation, and

7) Each heir remains liable for the recapture "lien."

A subsequent sale of the property to a non-qualified person will result in the recapture of the taxes saved under this provision.

The Economic Recovery Tax Act of 1981 makes several technical and substantive changes affecting each of the major areas of special use valuation. These changes cover pre-death qualification requirements, election requirements, valuation rules, post-death qualification and recapture rules. Table 5 provides a summary of the special use valuation changes.

Easing of Rules Extending Time to Pay Taxes

Under the previous law, taxes were not always immediately due and payable. They could be paid according to one of two installment plans. The first plan allowed tax payments over a 10-year period beginning 5 years after death if at least 65 percent of the estate consisted of a closely-held business such as a family farm or ranch. The second plan allowed tax payments over a 10-year period beginning immediately after death if more than 35 percent of the estate was comprised of the farm business.

ERTA repealed the second plan, reduced the requirements under the first and liberalized qualification procedures. Now, if more than 35 percent of the estate consists of the farm business, the first installment plan may be used. The new law also allows interest-only payments for the first 5 years before the 10 years of annual principal and interest payments are due. The interest rate is 4 percent on taxes due on the first $1 million of taxable assets. Any excess is taxed at current interest rates which are adjusted annually by the Federal government. Under ERTA, several features of the previous law were also relaxed:

- Up to one-half the business interest may be sold without accelerating the payment of the balance of estate taxes and interest outstanding under the installment payment of taxes.
- Heirs escape the acceleration of principal and interest if they transfer property, by reason of death, to a family member. This family member also has the transfer option.
- In contrast to the automatic acceleration of taxes under the old law because of delinquent tax payments, ERTA provides a 6-month grace period for delinquent tax payments. However, the delinquent payment is not eligible for the 4 percent interest rate and incurs an additional late penalty.

The changes affecting the installment payment of estate taxes can be used to a substantial advantage in estate planning. Table 6 provides an example of the income effect of investing deferred estate taxes over a 15-year installment period.

Changes in the Texas Inheritance Tax

The Texas inheritance tax laws were revised in 1981. Under the old law, there were five classes of heirs. Tax rates varied depending upon the heir's classification. A State inheritance tax return, similar to the Federal estate tax return, had to be filed. The taxes due were the greater of 1) the State inheritance tax estimate calculated on the State tax return, or 2) the Federal tax credit allowed for the payment of State taxes.

The new law simplifies the State inheritance tax filing requirements. The tax due is now the Federal tax credit allowed for the payment of State inheritance taxes.

Considerations for Estate Planning under ERTA

The Economic Recovery Tax Act of 1981 adds a new dimension to estate planning. Two basic estate tax changes under ERTA greatly reduce the number of estates subject to the federal estate tax: *the increase in the unified credit* and the *unlimited marital deduction.* Tax minimization is still encouraged. However, with the increase in allowable tax-free transfers, more estates can shift the emphasis in planning to a more equitable distribution of the estate.

Estate planners should carefully consider the new unified credit and the unlimited marital deduction when planning estate transfers. A married couple should plan to *use the full unified credit* of both spouses. Thereafter, they should carefully review the tax effects on the death of both spouses. Lack of planning may result in "stacking an estate" through the passive use of the unlimited marital deduction and a larger combined gift and estate tax bill for the couple.

The transfer of *qualifying terminable interests* under the new law will primarily benefit the children of the decedent. The new law allows the decedent's spouse to receive the income from property during the surviving spouse's lifetime and yet guarantees ultimate transfer of the property to their children upon the death of the surviving spouse without disqualifying the property from the gift or estate tax marital deduction.

Table 5. Summary of Changes in Special Use Valuation Election (some changes retroactive to January 1, 1977)

Tax Activity	Prior to ERTA	ERTA
Maximum reduction of gross estate	$500,000	$750,000*
Pre-death qualification and material participation	5 of 8 years prior to death by owner or member of decedent's family	5 of 8 years prior to: 1) Death or 2) Disability or 3) Retirement, by owner or qualified heir** *NOTE: Under ERTA, the property must still be in a "qualified use" by the decedent or a "qualified heir" at the death of the decedent.*
Election requirements for special use valuation	On timely filed estate tax return	Allows election on delinquently filed reports
Valuation rules	Cash rentals	Net-share rentals added
Post-death requirements for qualified heirs of "special use" property	Material participation	Active management**
Qualified use requirement	Heir(s) must continue qualified use during 15-year recapture period	2-year grace period followed by 10-year recapture period**
Post-death recapture rules	15-year lien	10-year lien
Basis of special use property	Its special use value	Can elect market valuation at date of decedent's death by payment of recapture tax based on FMV at death plus interest
Standing timber	Not part of special use valuation	May be included as part of special use valuation
Like-kind exchange	Might trigger recapture	Does not trigger recapture
Tacking (adding together periods of ownership)	Not allowed	Period of ownership, qualified use and material participation may be combined to meet time requirements in the case of traded or replacement property after condemnation
Real property purchased by heir from decedent's estate	Not qualified for special use valuation. No step-up in basis while owned by estate	Qualifies for special use valuation if bought by qualified heir. Step-up in basis in the estate allowed. Purchaser takes special use valuation as basis**

**The maximum limit on the use valuation reduction of the gross estate was increased over a 3-year period as follows:*

1980	*$500,000*	*1982*	*$700,000*
1981	*$600,000*	*1983*	*$750,000*

***This provision is retroactively applied to estates of decedents dying after 1976.*

The increase in the *gift tax annual exclusion* allows easier shifting of ownership to the next generation during the estate planner's lifetime without incurring any transfer tax. This change may encourage the incorporation of large estates. Estate owners could give away stock to reduce estate size and yet retain control through ownership of the voting stock. The increase in the exclusion, along with direct payments of tuition and medical expenses, which do not accrue as part of the gift tax exclusion, make possible many transfers which are gift-tax free. Previously, many such transfers would exceed the exclusion limit, resulting in a gift tax liability. From an income tax viewpoint, gifts of income producing property are also an excellent method of saving income tax dollars.

Estate planning should concentrate on *minimizing income taxes* during the estate transfer. The income tax value of the step-up in basis should be compared to income tax consequences of a pre-death gift or pre-death property sale. Higher tax-free transfer limits allow estate owners to retain assets, such as land, that have increased sharply in value and pass these assets through the estate to obtain a higher stepped-up basis. The income tax liability on the later sale will be reduced to the extent of the step-up in basis. Another example of income tax considerations include the passing of inventory property through the estate. Expenses involved in the production of inventory property could be deducted by a cash basis tax payer in the year the expenses are paid. The inventory property passed through the estate would receive a step-up in basis, thereby reducing or eliminating the taxable portion of the gain when sold. In taxable estates, a major way to save estate taxes is to give away rapidly appreciating property. Pre-death gifts or sale of property may trigger the recapture of certain previously deductible items such as investment credit, depreciation, soil/water conservation and land-clearing expense deductions. The transfer of property at death does not trigger recapture of any of these credits or deductions.

Properly prepared wills assure a smooth estate transfer to the survivors and avoid costly intestate probation. Through a will, an estate owner may make specific bequests, name an independent executor, eliminate the expense of bonding, name guardians for minors and distribute the estate as desired.

Trusts remain an excellent estate planning tool. Trusts may be used to manage property for beneficiaries, to distribute both income and principal and to reduce taxes. Trusts are particularly useful if minor heirs are involved who might gain an interest in real property.

Many smaller estates which *anticipated liquidity problems* under the prior law, may expect no estate

Table 6. Example of the income generated by deferring estate tax payments for 15 years.

Assume: $100,000 owed and invested at an 8, 10 or 12 percent Rate of Return.

Years After Death	Federal Estate Tax		Interest	Balance Income Earned		
	Owed	Paid	Paid @ 4%	@ 8% Rate	@ 10% Rate	@ 12% Rate
1	$100,000	$ 0	$ 4,000	$ 4,000	$ 6,000	$8,000
2	$100,000	$ 0	$ 4,000	$ 4,000	$ 6,000	$8,000
3	$100,000	$ 0	$ 4,000	$ 4,000	$ 6,000	$8,000
4	$100,000	$ 0	$ 4,000	$ 4,000	$ 6,000	$8,000
5	$100,000	$ 0	$ 4,000	$ 4,000	$ 6,000	$8,000
6	$ 90,000	$10,000	$ 4,000	$ 4,000	$ 6,000	$8,000
7	$ 80,000	$10,000	$ 3,600	$ 3,600	$ 5,400	$7,200
8	$ 70,000	$10,000	$ 3,200	$ 3,200	$ 4,800	$6,400
9	$ 60,000	$10,000	$ 2,800	$ 2,800	$ 4,200	$5,600
10	$ 50,000	$10,000	$ 2,400	$ 2,400	$ 3,600	$4,800
11	$ 40,000	$10,000	$ 2,000	$ 2,000	$ 3,000	$4,000
12	$ 30,000	$10,000	$ 1,600	$ 1,600	$ 2,400	$3,200
13	$ 20,000	$10,000	$ 1,200	$ 1,200	$ 1,800	$2,400
14	$ 10,000	$10,000	$ 800	$ 800	$ 1,200	$1,600
15	$ 10,000	$10,000	$ 400	$ 400	$ 600	$ 800
Totals			$42,000	$42,000*	$63,000*	$84,000*

**Note: Gross income earned before income tax.*

tax liability under ERTA. If a potential tax liability exists, it may be postponed by using the marital deduction. Consequently, investments may be selected or redirected for reasons other than a high degree of liquidity. To illustrate, under the 1976 law, a million dollar taxable estate would pay approximately $300,000 in taxes. Under ERTA, with correct estate planning, a million dollar estate could pass tax free.

Property qualifying for the marital deduction postpones estate tax from the death of the first spouse to the death of the remaining spouse. Tax goals should insure that the transfer provides for the surviving spouse for life, and then transfer the property to the next generation at the lowest tax costs.

This publication was reviewed by Judon Fambrough, licensed attorney, member of the State Bar of Texas, Texas Real Estate Research Center, Texas A&M University.

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