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Highlights of the 1976 and 1978 Federal Estate and Gift Tax Regulations

The 1976 Tax Reform Act (1976 TRA) dramatically changed the Federal estate and gift tax regulations. Further modifications were contained in the Revenue Act of 1978. (RA of 1978). This article will highlight the major provisions contained in these new laws--especially those of interest to farm families. Basically the 1976 law took effect January 1, 1977, with certain provisions phased in between 1977 and 1981. The 1978 law clarified some of the earlier provisions, suspended some, and added additional provisions. Careful attention must be given to effective dates, and future legislation, both in planning and settling estates. But above all, remember that while the new laws may alter the tax consequences of some estates, the basic need is still for everyone to do overall estate planning, so that your wishes and concerns for family and friends govern the settlement of your estate.

MAJOR FEDERAL ESTATE TAX CHANGES

Unified Estate and Gift Tax

The 1976 TRA provides a single unified rate schedule for Federal estate and gift taxes (Table 1). At death your estate value will include not only assets owned at death, but also the value of taxable gifts made during your lifetime (after 1976). In addition, a unified credit replaces the former \$60,000 exemption per estate (Table 2). For example, in 1982 a taxable estate of \$500,000 would have a tentative tax of \$155,800. Subtracting the unified credit of \$47,000 leaves a tax due of \$108,800. The equivalent exemption in Table 2 indicates that in 1978 for single persons, Federal estate taxes will occur once estates exceed \$134,000. Adding the full marital deduction of \$250,000 means a 1978 estate of \$384,000 may transfer free of federal tax when there is a surviving spouse. These amounts will increase to \$175,625 and \$425,625, respectively by 1981.

The unified credit also allows deferral of payment of gift taxes until the cumulative value of taxable gifts exceeds the equivalent exemption shown in Table 2. But this is a deferral of taxes, not an exemption, and is part of the means of taxing both lifetime (i.e. taxable gifts) and death time transfers at the same rate.

Marital Deduction

A change in the marital deduction will benefit some smaller estates. Formerly the marital deduction was always half of the adjusted gross estate. Now, the marital deduction is the larger of \$250,000 or half of the decedents adjusted gross estate. As always, the marital deduction cannot exceed the amount passing to the spouse through the estate. For estates under \$500,000, a marital deduction of \$250,000 may be possible, though not always advisable, in a total estate planning context.

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Table 1

Unified Rate Schedule for Federal Estate and Gift Taxes After December 31, 1976

Taxable transfer		Determining Tentative Tax*	
From	To	Tax on amount in column 1	Tax rate on excess of amount in Column 1
(1)	(2)	(3)	(4)
$ 0	10,000	0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	1,250,000	345,800	41%
1,250,000	1,500,000	448,300	43%
1,500,000	2,000,000	555,800	45%
2,000,000	2,500,000	780,800	49%
2,500,000	3,000,000	1,025,800	53%
3,000,000	3,500,000	1,290,800	57%
3,500,000	4,000,000	1,575,800	61%
4,000,000	4,500,000	1,880,800	65%
4,500,000	5,000,000	2,205,800	69%
5,000,000	And Over	2,550,800	70%

*Tentative because the unified credit and credit for gift taxes paid are then subtracted to determine the actual estate tax payable.

Table 2

Unified Federal Estate and Gift Tax Credit After December 31, 1976

Year of Transfer	Credit	Equivalent Exemption
1977	$30,000*	$120,666
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981 or later	47,000	175,625

*Limited to $6,000 for gifts after December 31, 1976 and before July 1, 1977.

There is also a special three year transition rule on wills and trusts containing a clause on a "maximum estate marital deduction formula." The maximum marital deduction, where $250,000 exceeds 50 percent of the gross estate, will not apply if the will or trust was created before January 1, 1977 unless: a) the clause is amended after 1976 and before death, b) a state law is passed relating formula clauses to the maximum provisions, or c) the decedent dies after 1976 and before 1979. The best procedure for someone with such a clause in a current will or trust is to contact your lawyer and have the document reviewed.

Carryover Basis of Inherited Property

A major change in the 1976 TRA was the elimination of the "stepped-up basis" to fair market value on property received by inheritance. Instead heirs were to receive the same basis on the property (carryover the decedents' basis) as the decedent had prior to his death. Thus even though the decedent may have avoided tax on the capital gains, a sale by the heirs would generate capital gain income. However, if the property was acquired prior to 1977, a "fresh start" rule allowed a partial step-up in basis to allow for any improvements, appreciation, and/or depreciation that took place between the time it was purchased and January 1, 1977. Readily marketable securities and bonds were to be valued according to market quotes as of December 31, 1976. But this necessitated a great deal of computation for items such as farm land, machinery, and other items whose value could not be readily determined.

The purpose of the carryover basis was to allow taxation on capital gains of items held till death. However, this was a sharply discussed provision, due to the complexity and cost of application. And in the Revenue Act of 1978 Congress suspended the carryover basis rules until 1980. In addition, they expect to write new legislation to deal with this area during 1980. But if they fail to reach agreement, the carryover basis provisions will again be in effect for persons dying after 1979. As a minimum, persons should try to establish cost and date of acquisition on property, including valuable personal property such as antiques and jewelry, in case carryover rules again take effect.

Postponement of the carryover basis rules until 1980 means that the income tax basis of property inherited after Dec. 31, 1976 and before Jan. 1, 1980 goes back to the value listed in the estate tax return. Under the postponed carryover basis provisions, heirs basically receive the decedents income tax basis. Thus heirs who have sold assets inherited after 1976 may owe less income tax. This can affect 1978 returns and may mean amended returns should be filed for 1977.

Sales of inherited property of farmers most likely to generate refunds are: 1) raised grain and feed, 2) raised livestock, 3) machinery and equipment, and 4) land. Crops raised after 1976 and livestock born after 1976 were especially vulnerable to generating income tax liabilities. Both have a zero basis to cash basis taxpayers, so inheriting such assets and assuming the decedents basis under the carryover basis rules meant that the entire sale price became taxable income to the heir. Basis adjustments on land and machinery to Jan. 1, 1977 values, also generally meant a lower basis to the heirs than the fair market value listed in the estate tax return. Postponement of the carryover basis provisions mean that the heirs will generate less taxable income from the sale of these items.

Holding Period On Sale of Inherited Property

Another clarification included in the 1978 RA concern the eligibility for capital gains on inherited property sold within one year of the decedent's death. The holding period on property received from a decedent - under either stepped-up basis or carryover basis rules - will be treated as sufficient to qualify for long-term capital gains treatment. This conforms to treatment prior to the 1976 Tax Reform Act.

Valuation of Certain Real Property

Property devoted to farming or other closely-held business may be valued in the decedent's estate at its use value rather than the highest market value as normally required. This can reduce the value of the gross estate, and, hence, the estate tax due. However certain provisions must be met, both prior to and after decedent's death if it is elected. Some of these provisions:

1. Property is going to a member of the decedent's family (spouse, parents, children, brothers, sisters, aunts, uncles, etc.).

2. Decedent or a family member materially participated in the farm or business operation in 5 out of any 8 year period before or after decedent's death.

3. Property was owned by decedent or family member in 5 out of the last 8 years.

4. Property was used for farming or closely held business by the decedent or family member in 5 out of the last 8 years.

5. Value of property (less debts and expenses) must be at least 50 percent of decedent's gross estate.

6. Cannot reduce value of the estate more than $500,000.

7. Heirs must request its use as part of a timely filed (within 9 months, plus extensions) estate tax return.

8. All affected heirs must agree to its use, and sign an agreement of consent for personal liability in case of its recapture.

In general, the use value is determined by dividing the average yearly gross cash rental of comparable land, less state and local real estate taxes by the average annual effective interest rate for all new Federal Land Bank loans. In Ohio, cash rents of $60 to $100 per acre on better land, taxes of

$6 to $10 per acre, and a 9 percent rate on new loans, would lead to "ag use" values of $600 to $1000 per acre. These values will often be only 40 to 60% of current sale prices of comparable farm land. Other valuation methods may apply, if comparable land cash rents are not available. These methods may still lead to sharp reductions in appraised value, but may be more vulnerable to challenges by IRS.

However, the law provides for recapture of any estate tax savings from this provision, if the farm is sold to a nonfamily member or ceases to be used as a farm or closely held business within 15 years of decedent's death. Taxes are fully recaptured during the first ten years and then phased out between ten and fifteen years. But there's no recapture if the heir dies within this 15 year period without converting it to a nonqualified use. In addition, the 1978 law allows the qualified heir to be discharged from his personal liability by furnishing a bond. To implement, the heir applies in writing to the Secretary of Treasury for a determination of the maximum amount of recapture tax on his interest. The Secretary must respond within one year.

Valuing the farm at its "ag use" value should lead to a smaller gross estate and less estate tax due. However, use of this value also reduces the basis (for income tax purposes) of the inherited property. And there needs to be full agreement among all heirs concerning distribution of estate tax savings and assuming of liability for recapture of those tax savings. If one heir receives the benefit of the savings, while another must assume all risk of recapture, alternate use valuation will probably not be elected.

Jointly-Held Property

The entire value of property held as "joint tenants with right of survivorship" by husband and wife is generally included in the decedent's estate. To avoid this the surviving spouse had to establish proof of contribution in it's purchase. The 1976 TRA provided some relief in this area for spouses (not for other joint survivors) providing 1) The property was acquired (or title rewritten) after December 31, 1976, and 2) Gift tax treatment was elected and gift tax reports filed at that time. By establishing the joint ownership in a transfer subject to gift tax, 50 percent of the property will be treated for estate tax purposes as belonging to each spouse. The Revenue Act of 1978 also extends such treatment to joint interests created before 1977 between husband and wife if the taxpayer elects to report the creation of the joint interest as a gift in a return filed for any calendar quarter in 1977, 1978, or 1979. But farmers should generally not hold title to land as joint tenants, since they lose much estate planning flexibility, especially in the estate of the second to die.

A related rule of special interest to farmers permits the executor to elect to exclude a portion of the value of jointly-owned property used for farming, other trade or business based on the original contribution and/or material participation of the decedent's spouse in the operation. Use of this rule cannot result in less than 50% of the value of joint interest property being included in the estate or reducing the gross estate by more than $500,000. The amount excludable considers spouses original contribution, plus assumed appreciation at a 6% annual rate. An additional amount may be excluded for up to 25 years of material participation by the spouse. The latter amount is based on a formula using cost, date-of-death, years owned, and assumed appreciation.

Spouses, who can prove contribution, should readily benefit. The value of their portion of the cost furnished, increased by 6% annual simple interest, will be excluded form the value of jointly held property in the estate. However, if the surviving spouse is the wife, it may be difficult for her to prove material participation in the business. In any event, the total of the two exclusions are limited to $500,000.

Generation-Skipping Transfers (GST's)

In the past GST's allowed avoidance of estate taxes on the money or property in the trust for one or more generations. The 1976 TRA law provides that most trusts skipping one or more generations established after June 11, 1976 will no longer avoid estate taxes. However, GST's up to $250,000 per child are allowed for trusts which involve the grantor's children and grandchildren, for example, son receives income from trust during his life and principal goes to grandchildren at his death.

There are also special provisions on trusts in existence as of April 30, 1976. Irrevocable generation-skipping trusts in existence at that time are not taxable. Revocable trusts or wills establishing a subsequent generation-skipping trust are likewise not affected so long as the will or trust is not revised after April 30, 1976 and the grantor dies before 1982.

Extension of Time to Pay Estate Taxes

The provision for spreading out the payments of estate taxes has been extended to fifteen years, providing at least 65 percent of decedent's estate is a closely held business. Interests in two or more businesses may be added, but only if decedent's interest is at least 20 percent in each business. A special 4 percent rate is allowed on deferred payment on the first one million dollar value of the estate and is increased to around 7 percent beyond this value. Only the portion of the tax due on the closely-held property is eligible for deferral.

Several provisions of the Revenue Act of 1978 relate to estate tax liens when alternate use valuation (Section 2032A) or extension of time to pay taxes (Sections 6166 or 6166A) are elected. These relate to subordination of liens, and relieving the executor from personal liability for unpaid taxes. The Revenue Act of 1978 also contains a family attribution rule that should allow more farms and closely held businesses to qualify for the extension of time to pay estate taxes. It allows stock or partnership interests held by the decedent's family to be taken into account and treated as held by the decedent as a single shareholder or partner to meet the limitation of 15 partners or shareholders.

MAJOR FEDERAL GIFT TAX CHANGES

Several changes in the gift tax laws are of importance to estate planning. The tax rates on lifetime transfers have been changed to equal those of the estate tax through the unified rate structure. In addition, the lifetime exemption of $30,000 that existed through 1976 has been eliminated. However, the $3,000 annual exclusion per donee remains in effect.

Substitution of Credit for Lifetime Exemption

The unified credit substitutes for both the $30,000 lifetime gift exemptions and the $60,000 estate exemption that existed in the law prior to January 1, 1977. Persons who used part or all of the $30,000 lifetime exemption after September 8, 1976 and before January 1, 1977 must reduce their unified credit by 20 percent of the exemption used.

Taxable Gifts Made Within Three Years of Death

The new law declares that all taxable gifts (i.e. all gifts except those of $3,000 or less per donee) within three years of death will automatically be included in the gross estate. In addition, the "gross-up" rule provides that gift taxes paid on gifts during this three year period, will also be added to the gross estate. A major advantage of making taxable gifts today is to stop further appreciation in donors estate, providing the donor lives at least 3 years after making the gift.

The Revenue Act of 1978 made several clarifications on the $3,000 annual gift exclusion. First, the full value of taxable gifts made within three years of death are included in the gross estate - no reduction for the $3,000 exclusion will be allowed. Second, gifts made within 3 years of death with a value of $3,000 or less when made, are not included in the gross estate, regardless of their value at the time of decedent's death. However, a gift of a life insurance policy with a cash value of $3,000 or less or a term policy with a paid premium of $3,000 or less, doesn't quality. Death of the insured-transferor within 3 years of transfer of policy results in inclusion of total policy proceeds in decedent's gross estate.

Carryover Basis of Gift Property

The recipient of property by gift still assumes the same basis for income tax purposes, as existed for the donor. Depending on the nature of the gift and the amount of tax paid, a portion of the gift tax relating to appreciation will be added to the basis.

Gift Tax Marital Deductions

The gift tax marital deduction has been changed to favor small estates. Now the first $100,000 of lifetime gifts to spouses are completely deductible. None of the next $100,000 is deductible. For lifetime gifts over $200,000 the marital deduction is 50 percent. In addition, the estate and gift marital deductions are integrated. For gifts under $200,000 the portion above 50 percent of the transfer is subtracted from the available marital deduction of the estate. For example, a \$100,000 gift to spouse is 100 percent exempt from gift tax. However, at death, \$50,000 (\$100,000 - 50% of \$100,000) must be subtracted from the available marital deduction.

Filing of Gift Tax Returns

Gift tax returns will only need to be filed after the quarter in which the total cumulative taxable gifts during the calendar year exceeds \$25,000. If total taxable gifts during the calendar year did not exceed \$25,000, then only one return will need to be filed for the calendar year. Filing of gift tax returns on a timely basis is necessary, and is determined by the act of making gifts, whether or not there is any gift tax due.

SUMMARY

This article briefly highlights the aspects of the 1976 and 1978 Federal estate and gift tax laws with major relevance for farm families. Several other features of the new law that will affect a small number of people are not discussed here.

The new laws are extremely complex and many questions remain to be resolved. Many IRS regulations are yet to be published. Several aspects of the new laws are bound to be challenged in court. The regulations and the outcome of the litigation will provide information to answer many unresolved questions. However, it is evident that the need for estate planning by farm families is just as important as ever.