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Inheritance and Gift Taxes on Illinois Farm Property

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INHERITANCE AND GIFT TAXES ON ILLINOIS FARM PROPERTY

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Twenty years ago few farmers were concerned about inheritance or gift taxes since the value of most farms was less than the tax exemptions. With increased values of farmland and equipment, however, concern about gift and death taxes on farm property has been growing. By good planning tax savings of $10,000 to $50,000 are not uncommon.

The purpose of this circular is to provide farm people with general information concerning inheritance and gift taxes and to give them some knowledge of the legal steps they can take during their lifetimes to reduce them. Satisfactory solutions to individual problems, however, will usually require expert help.

Farm Estate Plans — The Usual Goals

In any plan for disposing of their estate, most farm families want to attain certain goals. These goals are usually to:

Keep the farm or farms in the family.
Retain farm units of efficient size.
Settle titles before inheritance so that heirs may make improvements knowing that they will be able to keep and benefit by the improvements they have made.
Provide reasonable security for the parents for life.
Provide fair treatment for all the heirs.
Reduce taxes and probate costs.

At some point during the time parents are considering the complicated problems of disposing of their property, many will find it desirable to include the whole family in a discussion of various possible plans. Afterwards they will need to talk over their ideas with an attorney. One of the objects of this visit will be to find out what plan or plans offer the greatest tax advantage consistent with the arrangement most desirable to both parents and children. The family will also often need to consult others — a life-insurance underwriter, accountant, and trust officer. An attorney and these persons frequently work together as a team on an estate or property plan.

Every Estate an Individual Problem

In each family the best steps to take to reduce taxes on the estate will depend on such personal factors as the following:

How much the farm and other property is worth.
How title is held.
Whether both parents are living.
How many children there are.
How much personal property can be readily converted to cash.
How much life insurance there is.
Whether some of the children are interested in farming.

Other items could be mentioned, but these indicate that each family has an individual problem and that each family will have a choice of several possible solutions. No one tax formula fits every case. In fact, taxes do not usually merit first consideration. How the family desires to dispose of the property should be of first importance.

Three Kinds of Estate Taxes

Farm property in Illinois may be subject to three kinds of taxes: the Illinois inheritance tax, the federal estate tax, and the federal gift tax. Practically all farm estates — except small ones ($20,000 or under) left to close relatives — are subject to the Illinois tax. Some estates, depending on their size, will be subject to a federal tax as well. Whether there will be a gift tax depends on the size of the gifts and the period of time over which they are given.

Illinois inheritance tax

This is a tax imposed on the right to receive property from a decedent and is imposed on each person receiving a taxable inheritance. Before the estate is distributed, the administrator or executor deducts the tax from the share of each beneficiary. If a beneficiary receives only real estate, he pays the tax assessed against his share.

The value of the estate includes: real and personal property, property transferred in contemplation of death,[1] an incomplete gift,[2] a part of the value of property held jointly, and life insurance payable to the estate. Mortality tables and interest or income rates of 5 percent are

[1] Illinois law presumes that any transfer for insufficient consideration made within two years of death was made in contemplation of death.

[2] A gift is incomplete if the decedent retained an interest or control over the property until death.

used to value life estates.[1] Funeral expenses, administration expenses, local and federal taxes payable, and debts of the estate are deducted from the gross estate.

On gross estates larger than the exemptions, a return must be filed with the circuit clerk within 13 months of the death of the owner. The circuit judge, after hearing evidence on the appraised value of the property, determines whether a tax is due. The tax is payable to the county treasurer within 15 months of the death of the owner.

After the deductions have been made and any inheritance tax due the state has been paid, the remainder of the estate is distributed to those entitled to it. Bequests to charitable, educational, and religious organizations are usually tax-exempt.

The rate at which an inheritance is taxed depends on the relationship of the beneficiary to the decedent, the rate becoming higher as the relationship becomes more distant. The rate also increases with the size of the inheritance. Beneficiaries are divided into three classes, each class being granted a tax exemption.

Classes I and I(A). In *Class I* — father, mother, husband, wife, children and their spouses, and grandchildren — each beneficiary is entitled to an exemption of $20,000. Thus each beneficiary in this group may inherit as much as $20,000 without tax. The rates on amounts over $20,000 are:

First $50,000 or any part thereof	2 percent
Next $100,000 or any part thereof	4 percent
Next $100,000 or any part thereof	6 percent
Next $250,000 or any part thereof	10 percent
Any additional amount	14 percent

The tax on the sample estates shown below would be:

Amount above the $20,000 exemption	*Tax*	*Amount above the $20,000 exemption*	*Tax*
$50,000	$1,000	$250,000	$11,000
$100,000	$3,000	$500,000	$36,000
$150,000	$5,000	$1,000,000	$106,000

Class I(A) is composed of brothers and sisters of the decedent. The exemption is $10,000. The rate on any amount over $10,000 is the same as the rate in Class I. On the sample estates shown above for Class I, a brother or sister would pay $400 to $1,400 more tax.

Class II members — aunts, uncles, nieces, nephews, and their descendants — may exempt $500 each. The rates on amounts over $500 are:

[1] For further information, see "Illinois Inheritance Tax Law Manual." A copy may be secured from the Office of the Attorney General, Springfield; Illinois.

First $20,000 or any part thereof	6 percent
Next $50,000 or any part thereof	8 percent
Next $100,000 or any part thereof	12 percent
Any additional amount	16 percent

One who inherits the following amounts will pay the tax shown.

Amount above the $500 exemption	*Tax*	*Amount above the $500 exemption*	*Tax*
$50,000	$3,600	$100,000	$ 8,800
$70,000	$5,200	$150,000	$14,800

Class III consists of all other persons, the exemption being $100. The rates on amounts over $100 are:

First $20,000 or any part thereof	10 percent
Next $30,000 or any part thereof	12 percent
Next $50,000 or any part thereof	16 percent
Next $50,000 or any part thereof	20 percent
Next $100,000 or any part thereof	24 percent
Any additional amount	30 percent

One who inherits the following amounts will pay the tax shown.

Amount above the $100 exemption	*Tax*	*Amount above the $100 exemption*	*Tax*
$50,000	$5,600	$100,000	$13,600
$70,000	$8,800	$150,000	$23,600

Federal estate tax

This tax is imposed on the right to transfer property and is a tax on the net estate of a decedent.[1] Before the tax can be computed the gross estate must be determined. The gross estate includes: all real and personal property, transfers in contemplation of death,[2] revocable transfers,[3] transfers to take effect at or after death (if the decedent retained a reversionary interest worth more than 5 percent of the value of the property immediately before death), full value of joint tenancy property,[4] value of survivor's interest in a joint or survivor annuity, property held subject to power of appointment, and proceeds of insurance.[5]

The net estate is determined by subtracting from the gross estate

[1] A special credit is allowed for state inheritance taxes on estates over $100,000. If the Illinois inheritance tax is less than this credit, the difference is due the state and called the Illinois Additional Estate Tax.

[2] The federal law presumes that gifts made within three years of death were made in contemplation of death.

[3] A transfer is revocable if the decedent retained control over the property.

[4] Under some conditions joint tenancy property may not be subject to tax. It is not taxed if the survivor can trace the original acquisition of the property as a gift to himself from a third person, to funds which were his own, or to a gift to him and another.

[5] Insurance proceeds are included if the deceased retained any incidents of ownership, such as the right to change beneficiary or to cash in the policy.

such items as funeral and administration expenses, claims against the estate, unpaid mortgages, and gifts to charity. If the property is left to a surviving spouse, as much as half the adjusted gross estate (gross estate less such items as funeral, probate, and administration expenses, claims against the estate, unpaid mortgages, income and property taxes due prior to decedent's death) may also be deducted. This is the marital deduction. In addition, each estate is permitted an exemption of $60,000. Thus if the maximum marital deduction is used, a net estate of $120,000 may be transferred without a federal estate tax.

If the gross estate is more than $60,000, a return must be filed within nine months after the date of death and any tax due must be paid at that time by the estate.

The federal rate, like the Illinois rate, becomes progressively higher as the size of the estate increases. But the federal rates, unlike the Illinois rates, do not depend on the degree of relationship to the decedent. The rates on taxable estates of more than $60,000 are:

First $5,000 or any part thereof	3 percent
Next $5,000 or any part thereof	7 percent
Next $10,000 or any part thereof	11 percent
Next $10,000 or any part thereof	14 percent
Next $10,000 or any part thereof	18 percent
Next $10,000 or any part thereof	21.2 percent
Next $10,000 or any part thereof	24.2 percent
Next $30,000 or any part thereof	27.2 percent

Rates continue to increase to a maximum of 62 percent.

The federal tax on estates of the following values would be:

Amount	*Tax*	*Amount*	*Tax*
$70,000	$500	$160,000	$20,140
$90,000	$3,000	$200,000	$31,500
$100,000	$4,800	$500,000	$116,500

A credit against the tax is allowed for any previous estate tax paid on property transferred to the decedent within the past 10 years. The credit ranges from 100 percent of the tax paid if property was received within 2 years of death to 20 percent within 10 years.

If a business controlled by only a few people or by one person, such as a farm, is included in the gross estate of the decedent; if the value of the interest in that business exceeds 35 percent of the value of the gross estate, or 50 percent of the taxable estate; and if payment within nine months would create a hardship; the executor may elect to pay part or all of the estate tax in 2 to 10 equal yearly installments. However, the amount that can be paid in installments is limited to the percentage the closely held business is of the entire estate.

Federal gift tax

This tax applies to gifts of property — both real and personal. The fair cash value of the gift on the market is used to determine the tax. If a farm is sold to a member of the family for less than the market value, the difference between the price paid and the market value is a gift and may be subject to a tax. The person who makes the gift pays the tax. The person receiving the gift pays neither income tax nor gift tax on the gift received. Gifts made to certain charitable, educational, and civic organizations are not taxable.

A person is allowed to give up to $3,000 a year to as many individuals as he wishes. For example, a father could give $3,000 to each of his children every year without becoming liable for gift tax. A husband and wife who make gifts jointly may each take this exclusion, even if one of them owns no property; thus, a husband and wife giving jointly could give each child up to $6,000 annually without becoming liable for gift tax.

In addition to the $3,000 annual exclusion, each person has a $30,000 lifetime exemption. The $30,000 exemption is depleted only when a gift to an individual exceeds the $3,000 annual exclusion. A husband and wife who make gifts jointly are allowed a $60,000 lifetime exemption. Thus a husband and wife with four children could make a total gift in one year of $84,000 ($21,000 to each child) by using both the annual exclusion and the lifetime exemption.

A gift from one spouse to the other is taxable on only half its value; this provision in the law is known as the marital deduction. The marital deduction does not apply to gifts of life estates or other limited interests unless the estate or interest is coupled with broad powers to use the property and to appoint a remainderman.

Gift-tax returns must be filed in any quarter in which gifts to one person exceed the annual exclusion of $3,000 ($6,000 when given jointly).

The rates above exemptions and exclusions are:

First $5,000 or any part thereof	2.25 percent
Next $5,000 or any part thereof	5.25 percent
Next $10,000 or any part thereof	8.25 percent
Next $10,000 or any part thereof	10.50 percent
Next $10,000 or any part thereof	13.50 percent
Next $10,000 or any part thereof	16.50 percent
Next $10,000 or any part thereof	18.75 percent
Next $40,000 or any part thereof	21.00 percent
Next $150,000 or any part thereof	22.50 percent

Rates continue to increase to a maximum of 57.75 percent.

The gift tax on amounts above exemptions and exclusions is:

Amount	*Tax*	*Amount*	*Tax*
$5,000	$112.50	$50,000	$5,250
$10,000	$375.00	$60,000	$7,125
$20,000	$1,200.00	$100,000	$15,525
$30,000	$2,250.00	$200,000	$38,025
$40,000	$3,600.00	$500,000	$109,275

Ways to Reduce Inheritance Taxes

Many farm families do not adopt estate plans that would reduce inheritance taxes because they fear that to do so is either illegal or unethical. Neither is the case. Many tax-saving devices are legitimate, are used by good business managers, and are in no way immoral. For example, the members of a corporation can dissolve the corporation to avoid corporation taxes and form a partnership instead, and no one can object to their action on either ground. Likewise, no one can object to a farmer's transferring title to his children to avoid high estate taxes.

By gifts. One of the best ways of reducing state and federal taxes on estates is by gifts. The gifts may be cash, real estate, or securities. Gifts not only reduce taxes on an estate by reducing net value, but they also reduce administration and probate costs since property given away does not have to be administered and probated.

The tax on a sizable gift made in one sum may be quite heavy (see taxes on gifts, page 7). However, if the givers make small gifts repeatedly over a period of years, they may either avoid a gift tax entirely or pay only a small tax. But even if a gift is large enough to be taxed, the gift tax is usually less than the inheritance and estate taxes on the same property would be if the owner kept it until his death. The primary reason for this is that the gift tax on the first several thousand dollars is computed at rates in the low brackets, and the property is taken out of the high brackets of the inheritance-tax rates where it would otherwise be taxed.

Other advantages of using gifts in estate planning are these: gifts reduce the income tax of the giver because the income from transferred property is then removed from his high income-tax bracket; and parents who have means enough to make gifts to their children may furnish the children with capital at an age when the children most need the money to buy a farm or equipment.

If a gift is to reduce inheritance taxes, however, *it must be complete with no strings attached.* This is a basic tax rule. If the giver retains any rights in the property, such as control of it or income from it, the property will be subject to inheritance taxes.

In general, the giver had best make a gift while he is in good health and actively engaged in business. A gift made within three years of death (two years for the Illinois tax) is presumed by law to have been made in contemplation of death and is included in the taxable estate.

By sale. Reducing the value of an estate by sale to an heir is another means of cutting state and federal taxes. This method works only if all the proceeds of the sale are not reinvested. If the parents need continued income, they may take annual payments and use them for living expenses. A sale under these conditions may also bring about a saving on income tax since payments would be a return of capital (not taxable) and any profits would be taxed at capital gains rates. If, however, the tax basis (cost) of the property is very low compared to market value, the capital gain may be so high as to make a sale undesirable.

By distribution. Because the Illinois law allows each beneficiary who is a close relative of a decedent a $20,000 exemption, the state tax is less when the property is divided among several close members of a family. This provision for exemption becomes increasingly important as the size of the estate increases (see Examples 2 and 3, pages 11 and 12).

On estates of $60,000 and over, the greatest saving in federal taxes on the first transfer of property is usually made when the surviving parent takes half the adjusted gross value of the estate. On an estate of $120,000, if the surviving parent takes half and the other half is divided equally between two children, there is no federal tax. The Illinois tax is $1,200.

In order to get a true picture of tax costs, however, taxes on the transfer of the property of both parents need to be estimated. The marital deduction is not available to the surviving parent (except upon remarriage), and without this deduction the federal tax on a net estate of $120,000 is $9,340. Whether it will be best to leave all, at least one-half, or a smaller portion of the estate to the surviving spouse will depend on the estimated taxes on the combined estates. Each estate must be studied separately for the best answer.

The marital deduction provided in the federal law is not allowed on simple life estates and contingent interests (title held dependent on the occurrence of some event). For this reason, the tax is usually highest when the surviving parent takes a life interest or the children take all. On an estate of $60,000 plus $12,000 in life insurance, the federal tax is $720 when the surviving parent takes a life interest. The federal tax is the same when the children receive all the property. By leaving a portion of the property outright to the surviving parent (in this example, at least $12,000), the federal tax can be eliminated.

Though the tax is higher on the first transfer of property, the disposal of an estate can be planned to make a substantial tax-saving on a second transfer. For example, if the first beneficiary has only a life interest or an income interest in a trust, taxes and costs are largely avoided on transfer to the remainderman. Either can be set up in such a way as to skip inheritance taxes for one or even two generations.

By other methods. A power of appointment can be used to save taxes. (A power of appointment is the right of a person who receives a life interest or benefit to name the one who is to take the property when the life interest ends.) Taking property out of joint tenancy and placing it in tenancy in common is frequently advisable for large estates to save tax costs. The establishment of a family partnership may reduce taxes. Life insurance payable to an individual, not the estate, will save on state inheritance taxes.

Choice of means. This discussion of the various ways of reducing inheritance taxes indicates that a family planning the disposal of an estate faces a wide range of alternatives. Choosing the means best suited to a particular situation requires expert guidance. The best solution to the problem of one family may not be the answer to the problem of another family.

Taxes on Small, Medium, and Large Estates

The following examples show state and federal taxes on small, medium, and large estates when disposed of in various ways. In each instance the marital deduction was taken on the federal tax. In Illinois life insurance is not taxed unless paid to the estate, but if the decedent retains rights of ownership in the policy, all life insurance, no matter to whom paid, is subject to federal tax.

Example 1 — small estate. The family consists of husband and wife. The husband who holds title leaves an estate of $24,000 composed of: an 80-acre farm, $14,000; operating equipment, $2,000; bonds, $3,000; and life insurance payable to his wife as beneficiary, $5,000. Expenses, debts, and a mortgage total $2,500.

If the husband leaves all his property to his wife, there will be no tax, either state or federal. But any large amount he leaves to a distant relative or nonrelative will be subject to a high state tax. If he leaves half to his wife and half to a friend, the Illinois tax will be $825, the federal tax nothing.

Example 2 — estate of medium size. The parents have two children who are minors. The husband who holds title leaves a net estate of $72,000, but since $12,000 of this is in insurance payable to his wife, state inheritance taxes will be computed on an estate valued at $60,000. His assets are: a 200-acre farm, $35,000; operating equipment, $5,000; bonds, $10,000; city property, $15,000; and insurance, $12,000. Expenses, debts, and a mortgage amount to $5,000.

If the father of this family had given his wife $7,000 in bonds and other securities and had given his children city lots in trust valued at $5,000, he would have reduced the net value of the estate taxable in Illinois from $60,000 to $48,000.

The Illinois and federal tax on this estate when distributed in various ways and not reduced by gifts, and when reduced $12,000 by gifts is shown below.

Manner of distribution	Tax, estate *not* reduced by gifts			Tax, estate reduced by gifts		
	Illinois ($60,000 taxable)	Federal ($72,000 taxable)	Total	Illinois ($48,000 taxable)	Federal ($60,000 taxable)	Total
Entire estate to wife	$800	0	**$800**	$560	0	**$560**
Wife one third, each child one third	0	0	**0**	0	0	**0**
Wife one half, each child one fourth	200	0	**200**	80	0	**80**
Life estate to wife, remainder to children: life estate value, $30,000	200	720	**920**	200	0	**200**
Entire estate to children[a]	400	720	**1,120**	160	0	**160**
Wife one half, cousin one half	2,160	0	**2,160**	1,560	0	**1,560**

[a] In Illinois, a spouse can renounce a will and take the share of the property that is allowed by law — one third if there are children.

Example 3 — large estate. In a family of four the father who holds title leaves besides his wife two heirs who are adult. His net estate is valued at $220,000. Of this amount $190,000 is subject to Illinois inheritance tax. His property consists of: a 400-acre farm, $180,000; operating equipment, $20,000; bonds, $15,000; city property, $25,000; and insurance payable to his wife, $30,000. His expenses, debts, and a mortgage total $50,000.

If the father of this family had deeded the city property to his wife and given each of his children 80 acres of farmland, he would have reduced the net value of his estate by $85,000 ($25,000 city property and $60,000 farmland). At his death, the net value of his estate would have been $135,000. This amount would be subject to federal tax, but since insurance payable to a surviving spouse is not taxed in Illinois, only $105,000 would be subject to the state inheritance tax.

The Illinois and federal tax on this estate when it is transferred in one of several ways and not reduced by gifts and when reduced $85,000 by gifts is shown below.

	Tax, estate *not* reduced by gifts			Tax, estate reduced by gifts		
Manner of distribution	Illinois[a] ($190,000 taxable)	Federal ($220,000 taxable)	**Total**	Illinois[a] ($105,000 taxable)	Federal[b] ($135,000 taxable)	**Total**
Entire estate to wife	$6,200	$6,920	**$13,120**	$2,400	$325	**$2,725**
Wife one third, each child one third	2,600	16,593	**19,193**	900	3,000	**3,900**
Wife one half, each child one fourth	3,100	6,920	**10,020**	900	325	**1,225**
Life estate to wife, remainder to children: life estate value, $100,000	3,200	37,020	**40,220**	.....	.....	.....
life estate value, $42,000	.....	.....	.....	900	13,420	**14,320**
Entire estate to children[c]	4,000	37,020	**41,020**	1,300	13,420	**14,720**
Wife one half, cousin one half	10,140	6,920	**17,060**	4,410	325	**4,735**

[a] The Illinois Additional Estate Tax is not included in these computations. To include it would increase the state tax slightly in some cases.
[b] If all gifts were made in one year, the federal-gift tax would be $4,590. If these gifts were made during a period of six years, there would be no gift tax.
[c] In Illinois, a spouse can renounce a will and take the share of the property that is allowed by law — one third if there are children.

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