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Current Estate Law

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There have been questions raised regarding how to plan an estate with the new law enacted as a part of the American Taxpayer Relief Act of 2012 (ATRA). There has been a lot of coverage on the income tax aspects of the new law, but not much has been written on the estate tax aspects.

Federal Exemption Amount

The estate provisions in ATRA are as good as or even better than we could have anticipated. First, the law was made permanent (or as good as permanent is possible in Washington.) There will be no more getting to the end of the year and not knowing what the law will be the next year. We now have a \$5 million federal exemption amount that is indexed for inflation. It is \$5.25 million for deaths in 2013. However, Congress did increase the top tax rate from 35% to 40%, but that only applies after you exceed the exemption amount. Remember, for a married couple, each person has the \$5.25 million exemption so the couple can have a \$10.5 million estate without being subject to federal estate tax if both die in 2013.

The provision allowing unlimited gifts to a spouse has been retained. Consequently, if one spouse has a federal estate of \$8 million and the other of \$2 million, the spouse with the higher estate could transfer property valued at \$3 million to the other spouse. This would leave both with a \$5 million estate. However, a genuine transfer is required.

Portability

The new law retains the portability feature. This means that if the first to die has an estate of less than \$5.25 million, the unused exemption amount can be transferred to the surviving spouse. Assume Harry and Sally, husband and wife, have estates of \$3 million and \$4 million respectively. If Harry dies in 2013, he will only use \$3 million of his federal exemption leaving \$2.25 million unused. Assuming Harry's executor files a federal estate tax return, they can elect to pass the unused \$2.25 million exemption to Sally, who now has a \$6.25 million exemption available at her death.

While it might not seem important to make the portability election in small estates, you never know what can happen in the future. Maybe the surviving spouse will inherit property or win the lottery and have a huge estate at death. Adding the deceased spouse's unused exemption could save thousands of dollars of estate tax.

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Lifetime Gift

Another part of the new law makes the unification of the gift tax and the federal exemption amount permanent. In 2012, taxpayers could make gifts totaling \$5.12 million during their lifetime, but the federal exemption amount was reduced by the same amount at death. Before the new law was passed, there was concern that if the federal exemption amount dropped back to \$1 million, the IRS could “claw-back” the gift to \$1 million. This is no longer a concern. Gifting makes economic sense because all future appreciation of the gifted asset is with the Donee and is not in the Donor’s estate.

For example, Charles owns 11,000 acres of prime Illinois farm land. In January 2012, he gifted 500 acres valued at \$10,000 per acre to his three children and used \$5 million of his federal exemption. Charles dies in 2014 when land in his area is valued at \$15,000 per acre. Because of Charles’s gifts, the \$5,000 per acre increase is recognized by his children saving the estate the tax on \$2.5 million at a 40% rate, or \$1 million. Not everyone has estates this large, but with the rapid increase in farm land, many land owners are learning they could have a substantial estate tax at the time of their death.

The disadvantage to a gift is that the Donee’s basis in the gift is the same as the basis when the asset was held by the Donor. For example, in the prior example with Charles, he only paid \$600 per acre when he purchased the land years ago. Therefore, if his three children sell the land upon receiving it as a gift, they will have a \$4.7 million gain ((\$10,000 price per acre – \$600 basis) x 500 acres) to recognize.

Annual Gift Limitation

The annual gift tax exclusion continues to be in effect. This means you can make gifts totaling up to \$14,000 in 2013 to as many individuals as you want without reducing the federal exemption amount. Any excess gifts do reduce the exemption amount. Both husband and wife can make a \$14,000 gift. A spouse can join in a gift even though they do not have an asset to gift. For example, Tom and Helen were recently married. Tom has large cash accounts while Helen has only a limited amount of cash. Tom and Helen can each gift \$14,000 to Tom’s son even though Helen is gifting Tom’s money. Helen must acknowledge that she will not make a gift to Tom’s son with her money.

Basis

The new law continues to allow a step-up in the basis of the deceased’s assets to the fair market value at the date of death. This means an heir can sell an inherited asset without a huge tax liability. In the example with Charles, if the three children inherited the land in 2012, it would have a stepped-up basis of \$5 million. Therefore, a \$5 million sale would not result in any capital gains tax. If it were a gift, the \$4.7 million gain would be a long-term capital gain taxed at 20%, resulting in \$940,000 of capital gains tax.

Farm-Use Valuation

IRC §2032A has also been retained. The reduction limit remains at \$1 million. To qualify for the deduction the following requirements must be met.

1. The decedent must have been a U.S. citizen at the time of death.
2. The farm land must be located in the U.S..
3. At the time of death, the farm land must be used for farming by the decedent or a member of their family.
4. The value of the gross estate must be composed of at least 50% qualified real or personal property that is used for farming by the decedent or a member of the decedent’s family.
5. At least 25% of the gross estate must consist of land being used for farming on the date of death.
6. The farm land must be inherited by a qualified heir.
7. For a total of five of the last eight years ending on the date of death or disability:
 - a. The real property was owned by and used for farming by the decedent or a member of the family, and
 - b. The decedent or a member of the family materially participated in the operation of the farm.
8. The executor must elect special-use valuation by submitting a written agreement signed by each person having an interest in the land covered by the election consenting to the recapture

provisions.

The savings from the use of §2032A must be recaptured when the land ceases to be farmed or is sold to a nonqualifying relative within ten years from the date of death of the decedent.

Extended Time to Pay

The estate tax is due within nine months of the date of death. However, there is a special provision for farmers and small businesses allowing for installment payments. For the first five years, the estate can pay interest only. For the next ten years, the estate must make equal payments on the tax owed. Because the last interest payment and the first installment payment coincide, the overall delay is 14 years. To be eligible for the extended time period, 35% of the estate must be composed of a farm or closely held business. The benefit is only available for the farm or business portion of the assets.

Illinois Estate Tax

Illinois continues to have a state estate tax. Unfortunately, the Illinois exemption is not as large as the federal exemption. For persons dying after 2012, the Illinois exemption amount is \$4 million. For deaths in 2013, any taxable gifts between \$4 million and \$5.25 million will be included in the calculations of the Illinois estate tax without any federal estate tax consequences.

Summary

This is an abbreviated summary of the estate tax provisions. Before making any decision regarding your estate, you should seek advice of a qualified accountant or attorney.