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Federal Estate Tax

MONTANA STATE UNIVERSITY EXTENSION

MontGuide

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This publication describes how federal tax laws affect individual estates, including changes resulting from The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. The estate tax section of the Act titled "Temporary Estate Tax Relief" contains provisions that apply during 2011 and 2012.

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THE FEDERAL ESTATE TAX IS A TAX AGAINST THE estate of a deceased person for the right to transfer property at death. The amount of the estate tax depends upon the value of the assets the decedent (the person who died) held at death, taxable transfers during life, how assets are titled, and deductions and credits available. In many cases, the potential estate tax can be reduced significantly by careful planning during life.

This MontGuide presents a general explanation of the federal estate tax provisions following The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. The estate tax section of the bill (Temporary Estate Tax Relief) contains provisions that apply during 2011 and 2012. During those two years the value of property that may be transferred free of the federal estate tax is $5 million. The provisions of this act are scheduled to end on December 31, 2012.

The Gross Estate

Calculation of the federal estate tax begins with the determination of a deceased person's gross estate. The gross estate includes: the fair market value of all real and personal property owned at death, transfers with retained life estate, transfers taking effect at death, revocable transfers, annuities, joint interests, certain powers of appointment, certain proceeds of life insurance, certain transfers occurring within three years of death, and future payments that were owed to the decedent at the time of death. An explanation of each follows.

Real and personal property owned by the deceased person

Property owned by the decedent includes real estate, stocks, bonds, checking and savings accounts, and promissory notes or other evidences of indebtedness held by the decedent. Also included in the gross estate are miscellaneous personal property (furniture, jewelry, personal effects), collections (works of art, coins, stamps, guns), and the decedent's business interests in a partnership, family corporation, or limited liability company.

Transfers with retained life estate

Generally, the value of the gross estate includes property transferred during life by the decedent if he or she retained possession, enjoyment of, or reserved certain rights or interests in the property. However, if the transfer was made for full consideration in money or money's worth at the time of the transfer, the value will not be included in the decedent's gross estate. Interests that an individual could reserve for life include the use, possession, or other enjoyment of the transferred property; the right to receive income; or the right to designate persons who may receive income from the transferred property. Any one of these provisions will bring the property back into the gross estate for federal estate tax purposes.

Also, the gross estate includes the full date-of-death value of closely-held corporate stock if a decedent transferred the stock but retained voting rights for the transferred stock.

The value of property that a decedent transferred, but retained the right to income or retained the right to live on or use the property is also included in the gross estate for federal estate tax purposes. This is true even though the property is validly transferred according to Montana law.

Example A: Jack deeded his ranch to his son in 2006. However, Jack continued to live on the ranch, made management decisions, and received income from the operation. In this case, the Internal Revenue Code provides that he had retained a life interest in the property regardless of how the legal paperwork was written up. The value of the ranch at the time of Jack's death in 2011 was included as a part of his gross estate.

Transfers taking effect at death (reversionary interests)

If a transfer was not made for full consideration in money or money's worth (reversionary interests), the gross estate includes the value of property interests transferred at death if all of the following conditions exist:

1. Only by surviving the decedent could the beneficiaries obtain possession or enjoyment of the property transferred.
2. A right to have the property returned to oneself (reversionary interest) was retained by the decedent.
3. The value of the reversionary interest immediately before the decedent's death exceeded 5 percent of the value of the entire property.

Example B: John transferred property to a trust with the income payable to his wife for life and the remainder payable to himself or, if he is not living at his wife's death, to their child. John held a reversionary interest by the terms of the trust. He had expressly retained the right to have the property returned to him in the event that he survived his wife, a right he possessed up to the moment of death. If the value of the reversionary interest was greater than 5 percent of the trust value, the value of the trust will be included in John's gross estate.

The value of the reversionary interest is based on actuarial tables. In other words, the value of the reversion depends on the likelihood that the person establishing the trust will survive his or her beneficiaries.

Revocable transfers

The gross estate includes the value of property interests transferred by a decedent, unless the transfer was made for full consideration in money or money's worth, if the enjoyment of the property transferred was subject, on the date of death, to any power of the decedent to alter, amend, revoke or terminate the transfer.

One example of a revocable transfer is a revocable living trust. While one purpose of a revocable living trust may be to reduce or eliminate probate expenses, the assets in a revocable living trust are still included in the gross estate and subject to federal estate taxes. The power to change beneficiaries and the power to increase any beneficiary's enjoyment of the property are other examples of revocable transfers.

Annuities

The gross estate includes the value of an annuity or other payment that a beneficiary is due to receive because he or she survives the decedent. The amount included is proportionate to the purchase price contributed by the decedent or by the decedent's employer relative to the total purchase price of the annuity. A single life annuity contract that provides periodic payments to the decedent for life and ceased at his/her death is not included in the gross estate for federal estate tax computation purposes.

Joint tenancy with right of survivorship interests

If property is titled by a husband and wife as joint tenants with right of survivorship, then the estate of the first spouse to die includes one-half of the value of property regardless of which spouse paid for purchase of the property. This rule applies as long as the decedent and the surviving spouse are the only joint tenants on the property title.

Example C: A husband purchased a farm for $200,000 and titled it in joint tenancy with right of survivorship with his wife. When the husband died in 2011, the farm had increased in value to $4 million. Because the farm was in joint tenancy between husband and wife only, one-half the value of the farm ($2 million) was included in the husband's gross estate for determining the federal estate tax.

When property is jointly owned by a decedent and someone other than the decedent's spouse, different rules apply. The entire value is included if the first joint tenant to die furnished all of the funds for the purchase. A prorated share is included if each owner contributed to the cost of the acquisition of the jointly held property. For this reason, owners need to have good records to establish who contributed to the acquisition and improvement of the property and in what amounts.

Example D: A father placed his ranch valued at $2.5 million in joint tenancy with right of survivorship with his son. He had made no other taxable gifts during his lifetime and his other assets were of limited value. Upon the father's death in 2011, the son could not prove he contributed funds for the purchase price. As a result, the entire value of the ranch ($2.5 million) was included in the father's gross estate for determining the federal estate tax.

An exception is allowed, if the personal representative of the estate (the person who assists with the settlement of an estate; formerly called "executor" or "administrator") can prove that the surviving non-spouse joint owner provided part or all of the money when the property was acquired or when the mortgage was paid off.

Example E: A father and his son bought a farm for $300,000. Each provided half of the funds for the purchase. The father had made no other taxable gifts during his lifetime. When the father died in 2011, the farm was valued at $6 million. The amount included in the father's gross estate for federal estate tax purposes was half of the value ($3 million) because he had contributed half of the original purchase price.

The burden of proof is on the decedent's estate to prove the amount and source of contribution on the part of the surviving joint owner or owners, unless the surviving joint owner is a spouse. Records are needed to document when the property was acquired, what consideration was furnished and by whom. In the absence of such records, the full value of the property will be included in the value of the taxable estate.

Powers of appointment

The gross estate includes the value of property interests over which the decedent had a general power of appointment at death. A power of appointment is the power to determine who will own or enjoy a property or an interest in the

property, at present or in the future. In essence, if the decedent retained the "right to direct" the property, the value will be included in the gross estate.

If the holder can appoint property to himself, his creditors, his estate, or his estate's creditors he has a general power of appointment. The unlimited power to consume, invade, or appropriate either income or principal, or both for the benefit of the decedent prior to his/her death, will also be considered a general power of appointment.

Proceeds of life insurance

The proceeds from a life insurance policy on the decedent are included in the gross estate, if any one of the following conditions exists:

- The proceeds are receivable by the estate.
- The proceeds are receivable by another for the benefit of the estate or subject to a legal obligation to benefit the estate.
- The decedent possessed incidents of ownership in the policy (such as the power to change beneficiaries, to revoke an assignment, to pledge the policy for a loan, or to surrender or cancel the policy).

Example F: A mother owned a $500,000 life insurance policy and made the annual premium payments. She named her son as the primary beneficiary. When she died, the $500,000 passed to her son, but the value of proceeds ($500,000) were included in her gross estate, which also included her ranch valued at $4 million.

Example G: In 2006 a mother transferred ownership of her $1 million life insurance policy to her son, who then made the premium payments. Her son remained as the beneficiary. When the mother died, the $1 million in life insurance proceeds was not included in her estate because she was not the owner of the policy and she lived more than three years after the transfer to her son (see below). The federal estate tax would be computed only on the value of her $4 million ranch.

Insurance on the life of another, owned by the decedent at his or her death, is also included in the gross estate. The amount included is the replacement value of the policy, which can be obtained from the life insurance company.

Transactions within three years of death

Generally, the value of gifts (other than gifts of life insurance) made by a decedent is not included in the gross estate (although lifetime taxable gifts can reduce the amount of the applicable exclusion available to the estate). However, interests in property otherwise included in the gross estate under the so-called "strings attached" provisions (or that would have been included had the interest been retained by the decedent) are included in the gross estate if transferred within three years of death. In addition, any gift tax paid by the decedent or his or her spouse within three years of death will be included in the gross estate for federal estate tax computation purposes.

Example H: Assume that a father owned a term life insurance policy with proceeds of $500,000 payable at his death. In 2011, he transferred ownership to his daughter, who is also the beneficiary. She is now responsible for paying the premiums. No other taxable gifts had been made by the father in prior years.

In the year 2012, the father dies owning ranch land valued at $5 million. The life insurance proceeds ($500,000) pass directly to his daughter. However, the value is included in the father's gross estate for federal estate tax computation purposes because he did not live three years after transferring ownership of the policy to his daughter. The father's gross estate includes the life insurance policy proceeds ($500,000) and other property ($5 million value in ranch land) for a total value of $5.5 million. The father has an applicable exclusion of $5 million. Because the father died within three years of the transfer of the life insurance policy, his estate owed $175,000 in federal estate taxes on the $500,000 that was above the applicable exclusion.

Example I: If the father lives at least three years (died in 2015 and assuming the federal law doesn't change) after transferring ownership of the policy to his daughter, the $500,000 in proceeds would not be included in his taxable estate. The federal estate tax would be computed on $5 million instead of $5.5 million and no federal estate tax would be due because of the $5 million applicable exclusion (see Table 2, page 5).

Valuation of Gross Estate

Generally, the value of the decedent's property interest for federal estate tax purposes is its *fair market value* at the date of death. The IRS defines the *fair market value* as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts.

The personal representative may elect an *alternate valuation* of the assets as of six months after the decedent's death. If the alternate valuation is elected, then ***all*** assets must be valued as of the alternate date, or as of the date of their distribution, sale, exchange, or other disposition, if any of those events occurs after a decedent's date of death and before the alternate valuation date. The alternate valuation can be elected ***only*** if the valuation reduces the size of the gross estate and also reduces the amount of federal estate tax due.

Basis of property

All property (real estate, stocks, and bonds) that a person owns has a basis for tax purposes. For example, a home purchased years ago for $47,000 has a basis of $47,000 even though its current fair market value is $250,000.

Property received by a donee as a gift from a donor during life has a carry-over basis value. This means that the basis that passes to the donee is the same as it was for the donor.

Example J: A father gives land to his daughter that has a fair market value of $3 million. The father paid $100,000 for the land. Because the transfer is a "gift," the daughter assumes her father's $100,000 basis in the property. If she sells the property for $3 million, she is responsible for the income tax on the capital gain which is the difference between the basis ($100,000) and the fair market value ($3 million). Thus, after the sale of the land the daughter would owe a federal income tax of $435,000 on the $2.9 million capital gain (assuming a capital gains tax rate of 15 percent).

Property that is received by a beneficiary from a decedent has a stepped-up basis. This means the basis of the property is *stepped-up* to the fair market value at the date of death of the owner.

Example K: If the property in Example J had passed to the daughter as a result of her father's death in 2012, she would have received a *stepped-up* basis on the property. This means the basis in the property would be *stepped-up* from the father's $100,000 basis to $3 million, the value at her father's death. If the daughter sold the property for $3 million after her father's death, there would be no income tax on the capital gain because she sold the property at the *stepped-up* $3 million basis value.

Special use valuation on real property

If the personal representative has an agreement signed by those receiving an interest in real property to assume personal liability for recapture of federal estate taxes, he or she may elect to value qualified real property as a farm or ranch or as its use in the closely held business, rather than at its fair market value.

The s*pecial use valuation* cannot reduce the decedent's gross estate by more than $1,020,000 million in 2011 (indexed for inflation in subsequent years). For property to qualify for *special use valuation,* certain requirements must be met.

- The land must have been used as a farm for 5 years during the 8-year period ending with the decedent's death.
- The decedent or a member of the decedent's family must have materially participated in the farm business.
- The land must comprise at least 25 percent of the gross estate.
- The land must pass to qualified heirs (generally a lineal descendant of the decedent, a spouse of the lineal descendant or ancestor of decedent).
- The land and other farm or business assets must comprise at least 50 percent of the gross estate.

All or a portion of the federal estate tax benefits obtained under the special use valuation provision must be repaid if the property is sold to a nonfamily member or if the property ceases to be used for farming within 10 years following the decedent's death.

Adjusted taxable gifts

Total taxable gifts beyond the annual exclusion (currently $13,000 for each person) made by the decedent after December 31, 1976 are also included as adjusted taxable gifts on the Estate Tax Return (Form 706).

Allowable Expenses and Deductions

After the appropriate values are established for the gross estate the amount is reduced by subtracting the allowable expenses and deductions. Allowable expenses include such items as: administration expenses, funeral and medical claims against the estate, obligations, and casualty and theft losses. Allowable deductions include the marital deduction and the charitable deduction.

Allowable expenses

Administration expenses. Deductible administration expenses include compensation to the personal representative who is responsible for settling the estate, fees to the attorney for handling legal aspects of the estate, and miscellaneous expenses such as accountant's fees, court costs and expenses for selling estate property (if a sale is necessary to settle the estate). These deductions may be taken either on the federal estate tax return or the fiduciary income tax return, but not on both, and a timely election is required if taken on the fiduciary federal income tax return.

Medical Expenses. Medical expenses for the decedent are fully deductible on the federal estate tax return if they are not taken as a deduction on the decedent's income tax return.

Funeral Expenses. Funeral expenses for the decedent are fully deductible on the federal estate tax return.

Claims against the estate. All debts of the decedent, such as property taxes accrued before death, unpaid income taxes on income received by the decedent during life, and unpaid gift taxes on gifts made by the decedent during life are deductible from the gross estate.

Obligations. Unpaid mortgages and other charges against property, including the interest accrued to the date of the decedent's death, are deductible if the value of the property is included in the gross estate without reduction for mortgage or other indebtedness.

Casualty and theft loss. Deductions are allowed for losses incurred during the settlement of the estate that arise from theft or casualties, such as storms or fires. However, the deduction allowed is only to the extent that the losses are not compensated for by insurance and if they are not deducted on the estate's income tax return.

CHART 1: Unlimited marital deduction to surviving spouse at death of husband (Example M).		
	Husband's Estate	**Wife's Estate**
Estate Value	$5,000,000	$5,000,000
Marital Deduction	– $5,000,000	– $0
Taxable Estate	$0	$5,000,000
Tentative Tax	$0	$1,730,800
Applicable Credit	– $1,730,800	– $1,730,800
Estate Tax	0	0

Allowable deductions

Charitable deduction. An unlimited deduction is allowed for the value of property in the decedent's gross estate that was transferred by a will, a trust, a payable on death designation, a transfer of death designation, or a beneficiary designation to or for the use of a "qualified" 501(c)(3) charitable, religious, educational or governmental organization.

Example L: In his will, a 4-H leader left land valued at $2 million to the Montana 4-H Foundation. The amount would qualify as a charitable deduction on the federal estate tax return because the Montana 4-H Foundation is a 501(c)(3) organization.

Marital deduction. Generally, the value of unlimited amounts of property can be transferred at death to a U. S. citizen spouse without a federal estate tax being due.

Example M: Assume a husband has a taxable estate valued at $5 million in 2011 and that his wife has zero assets. If he leaves his estate all to his wife, there is no federal estate tax at his death, because the total amount qualifies for the unlimited marital deduction. There is also no estate tax if the wife dies with an estate valued at $5 million because she has a $5 million exemption (applicable exclusion) (see Chart 1).

Federal Estate Tax Rate

After allowable expenses and deductions are subtracted from the gross estate, the federal estate tax rates are applied to the remaining balance (taxable estate). The federal estate tax is $155,800 on the first $500,000, and 35 percent of the amount over $500,000 in 2011 and 2012 (see Table 1).

Example N: A grandfather has an estate of $5.5 million that he bequeathed to his grandson. The tax on the first $500,000 is $155,800. The tax on the balance of $5 million is $1,750,000 ($5 million x 35% = $1,750,000). The total tentative tax before credits are applied against the estate tax is $1,905,800 ($155,800 + $1,750,000 = $1,905,800).

Credits Deducted from the "Tentative" Estate Tax

The following credits are deducted from the tentative estate tax: the unified credit (also termed applicable credit amount) and credit for tax on prior transfers.

Applicable credit. The applicable credit is a credit against the tentative federal estate tax or the federal gift tax due. The applicable credit in 2011 and 2012 is $1,730,800.

The applicable credit is applied against the gift or estate taxes otherwise payable. The actual value of an estate that may pass without a federal estate tax due during 2011 - 2012 is $5 million. In other words, during 2011-2012, the $1,730,800 applicable credit is equal to $5 million in assets that can be transferred without being taxed at death. The same amount can be transferred during life without a gift tax. There is only one applicable credit, however, not one for federal estate transfers and another one for federal gift transfers.

For example, if a decedent had made taxable gifts of $1 million during 2002 he would have used $345,800 of the applicable credit that was available (see Table 2). With the increased amount of applicable credit in 2011 he now has $1,385,000 remaining to use in determining the federal estate tax applicable credit ($1,730,800 applicable credit - $345,800 used during 2002 = $1,385,000).

TABLE 1: Federal Gift and Estate Tax Rates 2011 and 2012

Taxable Gift or Estate		Tentative Tax	
From	To	Tax	Rate on Excess
$ 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		155,800	35%

TABLE 2: Applicable Exclusions and Credits 2001 - 2012

Federal Estate Tax Exclusions and Credits		
Year of Death	Applicable Exclusion	Applicable Credit
2001	$ 675,000	$ 220,550
2002 - 2003	1,000,000	345,800
2004 - 2005	1,500,000	555,800
2006 - 2008	2,000,000	780,000
2009	3,500,000	1,455,800
2010	N/A	N/A
2011 - 2012	$ 5,000,000	$ 1,730,800

The applicable credit translates into a dollar value that can be transferred during life without a federal gift tax due or at death without a federal estate tax due.

Example O: Jack, who made no prior taxable gifts to his children, had an estate valued at $6 million in 2011. The tax on the first $500,000 is $155,800. The federal estate tax on the remaining $5,500,000 ($6,000,000 - $500,000 = $5,500,000) is computed at a 35 percent rate. The result is $1,925,000. The tentative tax totals $2,080,800 ($1,925,000 + $155,800 = $2,080,800). From the tentative tax, the applicable credit of $1,730,800 is subtracted. The federal estate tax due is $350,000 ($2,080,800 tentative tax - $1,730,800 applicable credit = $350,000) (see Chart 2).

CHART 2: $10 Million Estate Using Dad's Applicable Credit (Example Q)

Estate Value	$6,000,000
Marital Deduction	– $ 0
Taxable Estate	$6,000,000
Tentative Tax	$2,080,800
Applicable Credit	– $1,730,800
Estate Tax	$ 350,000

Example P: George made a gift to his son of shares in his ranch corporation valued at $1 million in 2002. George did not have to pay a gift tax because the amount was equal to the applicable gift tax exclusion of $1 million in 2002. Based on the law in 2002 the amount translated to an applicable credit of $345,800 (see Table 2, page 5).

Assume George dies in 2011 with remaining stock valued at $2 million. In 2011 the applicable credit is $1,730,800 but because George already used $345,800 of his available credit in 2002, his estate only had a $1,385,000 applicable credit remaining ($1,730,800 - $345,800 = $1,385,000).

The applicable credits and applicable exclusions for both the federal estate tax and federal gift tax are listed in Table 2, page 5. For deaths in 2011 and 2012, a federal Estate Tax Return (Form 706) is required only when the value of the taxable estate and the value of the prior taxable gifts total more than $5 million.

Credit for tax on prior transfers. Partial credit is allowed against the tax for federal estate taxes paid on the transfer of property to the present decedent from a decedent who died within ten years before, or within two years after, the present decedent's death.

Filing of estate tax return

If the value of the gross estate of a decedent and the value of the taxable gift are more than the applicable exclusion amount ($5 million in 2011-2012 plus taxable gifts made during life), Form 706, Estate Tax Return, is due nine months after the date of death. A modified version of the return is provided in Chart. 3.

Extension of time to pay the tax

A reasonable extension of time (not to exceed six months) to file the estate tax return, or related statements or documents, may be granted if it is impossible or impractical to complete the return within the normal nine-month period beginning at the decedent's date of death. However, an extension of time to file the return is not an extension of time to pay the estate tax.

One-year extension. The personal representative may request an extension of time to pay the estate tax. A period not to exceed 12 months from the date fixed for the payment may be granted by the IRS when there is reasonable cause. However, interest accrues from the original due date.

Reasonable cause extension. The personal representative, when showing reasonable cause, may be granted an extension of time for paying taxes for up to 10 years from the due date of

CHART 3: Example of how the federal estate tax calculation works using the applicable credit amount for 2011 and 2012:

A.	Value of Gross Estate		$________
B.	Subtract		
	Claims Against Estate	________	
	Administrative Expenses (Probate Fees)	________	
	Funeral Expenses	________	
	Marital Deduction for Surviving Spouse	________	
	Charitable Deductions	________	
	Total Deductions	________	–________
C.	Taxable Estate		$________
D.	Add: All Post 1976 Adjusted Taxable Gifts		+________
E.	Adjusted Taxable Estate		$________
F.	Calculate Tentative Tax on "Adjusted Taxable Estate" Amount		$________
G.	Subtract: Total Gift Taxes Payable on Post-1976 Gifts		–________
H.	Gross Estate Tax Payable Before Credits are Applied		$________
I.	Subtract:		
	Estate Tax Applicable Credit	$1,730,800	
	Credit for Foreign Death Taxes	________	
	Credit for Tax on Prior Transfers	________	
	Total Credits		–________
J.	Net Estate Tax		$________
K.	Add: Generation Skipping Transfer Tax (if applicable)		+________
L.	Federal Estate Tax Payable		$________

the original payment of the tax liability. However, interest accrues from the original due date.

5 year deferral; 10 year installments. The estate tax attributable to a closely held business can be paid in installments if the value of the decedent's interest in the closely held business exceeds 35 percent of the decedent's gross estate. The estate can elect to defer payment of estate taxes that are due on the proportional value of the business. The election can delay tax payments by up to 5 years and then the estate can pay the taxes in up to 10 equal installments after the deferral. The result is that the estate can acquire up to 14 years to pay.

A special 2 percent interest rate is provided for deferred tax attributed to the first $1.36 million (as adjusted annually for inflation occurring after 1998) in value of the closely held business interest. The interest rate on deferred taxes on the remaining amount is 45 percent of the underpayment rate (federal short-term rate plus three percentage points). In April 2011 the rate was 1.8 percent.

The availability of installment payments for the federal estate tax for the closely held business is available for up to 45 shareholders or partners. Qualified lending and finance business interests are also eligible. The tax on these interests must be paid in five installments of principal and interest.

Estate planning goals

Protecting children from a prior marriage.
Assume that a father with two children from a prior marriage wants to provide not only for his wife, but also leave a legacy for his children. He wants them ultimately to inherit the land that has been in the family for several generations. His concern is that if he left the land to his wife she could remarry and the land could possibly pass out of the family. He contacted his attorney who recommended the following. Instead of leaving the land valued at $5 million outright to his wife, it would instead be placed in a qualified terminable interest property trust (QTIP). (See the Montguide, *Transferring Farm or Ranch Property to Next Generation Through a QTIP Trust*, MT200508HR).

The terms of the QTIP trust would require all income to be distributed to the wife for life, with the assets to pass to the husband's children at the death of the wife. With an appropriate election by the personal representative, the QTIP trust will qualify for the marital deduction at the death of the husband. While the property is subject to the federal estate tax at the death of the wife, there is no tax because the amount is equal to the wife's applicable exclusion of $5 million. Because of the terms of the QTIP trust, the husband will be assured that his assets will pass to his children from a prior marriage after the death of his present wife.

Another alternative is that the father could create a by-pass or credit shelter trust to hold the assets equal to the father's applicable exclusion. The assets in the credit shelter trust could pass directly to his children upon his death. (See the MontGuide, *Using a Bypass Trust to Provide for Children from Prior Marriage,* MT200509HR).

The law is very, very complex in this area. Contact an attorney or a certified public accountant for a full discussion of the factors to be considered for achieving family objectives and the minimization of federal estate taxes.

Minimizing taxes at the death of the surviving spouse.
By taking advantage of the *portability provision* of the deceased spouse's unused exclusion amount in the Temporary Estate Tax Relief section, federal estate taxes can be minimized at the death of the second spouse. With this *portability provision,* married couples can pass $10 million free of the federal estate tax.

The total exemption for a surviving spouse is the basic exclusion amount of $5 million plus any of the deceased's spousal unused exclusion amount.

Example Q: Assume a Father has a taxable estate valued at $10 million in 2011 and that the Mother has zero assets. They want to avoid federal estate taxes on their ranch that they want to eventually pass to their son.

If the husband leaves his estate all to wife, there is no estate tax at his death, because the total amount qualifies for the unlimited marital deduction. However, if the estate of the surviving spouse did not take advantage of the *portability provision* of the applicable credit, the federal estate tax on her $10 million estate would be $1,750,000 (assuming the wife died in 2012).

For a surviving spouse to take advantage of the *portability provision* section, however, the personal representative for the estate of the first deceased spouse is required to timely file IRS Form 706 (estate tax return) to establish the amount of the unused exclusion and elect on the return to allow the surviving spouse to use it. This is an irrevocable election.

Example R: Assume that in Example Q the wife takes advantage of the unlimited marital deduction and the full $10 million passes to her. The personal representative will need to file the federal Estate Return (Form 706) within nine months to establish the unused exclusion amount of $5 million and applicable credit of $1,730,800 from the estate of the husband.

There is no estate tax at the death of the husband because all $10 million passed to the wife utilizing the spousal unlimited marital deduction. When the wife dies there is no federal estate tax on the $10 million estate because of the unused exclusion of $5 million from the husband's estate using the *portability provision*. The result is that there is no federal estate tax at the death of both parents. The resulting tax savings for the estate that passes to the son is $1,750,000 (see Chart 3, page 8).

CHART 3: *Portability Provision* for Married Couples

	Dad's Estate	Mom's Estate
Estate Value	$10,000,000	$10,000,000
Marital Deduction	– $10,000,000	– $0
Taxable Estate	$0	$10,000,000
Tentative Tax	$0	$3,480,800
Applicable Credit	– $1,730,800	– $3,480,800
Estate Tax	0	0

However, if the surviving spouse remarries he or she loses the unused deceased spousal exclusion amount of the deceased spouse if he or she also survives the new spouse. The surviving spouse may only use the deceased spousal exclusion amount of the last deceased spouse.

Wills, trusts, and married couples.

All married couples who have executed wills should have them reviewed by an attorney to determine if the marital deduction clause overfunds a QTIP trust or credit shelter trust and does not provide adequately for the surviving spouse. This would apply to taxable and non-taxable estates.

Example S: Assume that a father has a $5 million estate. His will states that the credit shelter trust that will pass to their children should be funded at his death to the maximum amount of the applicable exclusion. If he died in 2011, $5 million (the maximum applicable exclusion) would pass to the credit shelter trust for their children and nothing would pass to his wife. That is not the result the husband had intended when he had the will written years ago. He needs to contact his attorney to change the terms of the credit shelter trust in the will to adequately provide for his spouse.

Changing Regulations

The Temporary Estate Tax Relief section of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 made changes in the federal estate tax statutes. While this MontGuide discusses some of the major changes, you are encouraged to consult competent professionals such as an attorney or certified public accountant to keep abreast of regulations as they develop. Also, consult these professionals for estate tax planning for your individual situation.

Further Information

The Internal Revenue Service provides in-depth publications on Federal Estate and Gift Taxation. They can be ordered from the IRS (1-800-829-3676) or downloaded from the web at www.irs.ustreas.gov.

Additional information about major changes in the regulations on gifting as a result of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 are explained in *Gifting: A Property Transfer Tool of Estate Planning* (MT199105HR). This MontGuide is available free from your local MSU Extension Office. Or contact MSU Extension Distribution Center, phone 406-994-3273, email orderpubs@montana.edu; or order online at www.msuextension.org/store.

Acknowledgments

Representatives from the following reviewed this MontGuide and recommend its reading by all Montanans who are in the process of estate planning.

- Business, Estates, Trusts, Tax and Real Property Section – State Bar of Montana
- Federal Taxation Committee – Montana Society of Certified Public Accountants
- University of Montana – School of Law

Disclaimer

This publication is not a substitute for legal advice. Rather it is designed to help inform persons about the basic provisions of the federal estate tax law and to create an awareness of the need for planning if a goal is to minimize the tax. There are numerous exceptions and conditions to some of the concepts discussed. Future changes in laws cannot be predicted and statements in the MontGuide are based solely on the laws in force on the date of publication.

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