Estate Taxes

The federal and state governments may impose a tax when you transfer property to someone else after you die and federal estate tax is imposed on most types of property that a person transfers at death.

Many examples of property are obvious:

- stocks
- cash
- real estate

However, the tax can also be imposed in situations in which the deceased does not own the property but can direct where it passes.

Determining all of the elements that make up an individual's gross estate for tax purposes is beyond the scope of this general discussion. Instead, you should consider the following major points as you begin to develop a strategy for minimizing or reducing your estate tax exposure.

Estate Tax Liability

The estate tax is progressive, so as the value of your estate increases, planning becomes more important. The marginal estate tax rate on a transfer of $10,000 is 18%, while the rate on a transfer in excess of $3,000,000 is 55%. The amount of tax computed is increased by 5 percent for taxable estates between $10 million and $17,184,000. This 5-percent surcharge eliminates the benefit of the graduated tax rates, resulting in an effective tax rate of 55 percent (60 percent in the phase-out range). Prior to the Taxpayer Relief Act of 1997, the 5-percent surcharge applied to taxable estates between $10 million and $24.1 million. The higher threshold eliminated the benefit of the unified credit. Congress may reinstate the unified credit surcharge in the future.

Realizing the implications of not doing proper estate planning is the first major hurtle you must overcome. Once you've realized the problem exists, it's important that you work with your attorney and accountant to determine the right course of action for your particular issues.

The estate tax is really a transfer tax because it applies to property transfers during lifetime (such as gifts) and at death (such as inheritances). As a result, an effective estate plan should consider both lifetime giving as well as the transfer of property at death. All such transfers may be subject to tax. More importantly, lifetime planning can significantly reduce any transfer tax liability at death.

Some types of transfers are excluded in determining the amount of a transfer that is subject to tax. For example, lifetime gifts from an individual of less than $10,000 per recipient per year are generally excluded from any transfer tax considerations. The $10,000 exclusion will be adjusted periodically for inflation.

In addition to the $10,000 annual exclusion, every individual taxpayer can transfer a certain amount of property during his or her lifetime without paying estate or gift tax due to a lifetime exemption amount. This exemption amount is used to calculated the credit available to offset the unified transfer tax. The exemption amount will increase to $1 million in 2006. The following table illustrates how the exemption amount will increase and the corresponding credit amount.

Increase in Lifetime Exemption Amount		
Transfers Made During Calendar Year(s)	**Applicable Exemption Amount ($)**	**Applicable Credit Amount ($)**
1999	$650,000	$211,300
2000-2001	$675,000	$220,550
2002-2003	$700,000	$229,800
2004	$850,000	$287,300
2005	$950,000	$326,300
2006 or later	$1,000,000	$345,800

For simplicity, the remainder of the examples in this publication will assume the applicable exemption amount is $1 million.

Estate administration expenses and debts can be deducted before computing any estate tax liability.

For a married couple, the primary deduction that reduces any gift or estate transfer tax is the marital deduction. This deduction is unlimited and permits one spouse to transfer any or all property to the other spouse free of tax. Thus, with proper planning, the estate transfer tax for married individuals can be deferred until the death of the surviving spouse. (Note: This deduction is generally only available for transfers to a spouse who is also a U.S. citizen.)

Amounts given to charity during lifetime or at death generally are not subject to any transfer tax.

After all exclusions and deductions have been considered, a tentative tax is computed on the remaining amount of transferred property. This tax can be offset by the applicable credit amount based upon the applicable exemption amount previously discussed. Thus, any estate with a total value less than the exemption amount will generally not be subject to any federal estate taxes.

Although the marital deduction allows for an unlimited amount of property to pass between spouses without transfer tax consequences, this deduction does not eliminate the need to develop an estate plan for the overall family. A simple estate plan under which everything passes to the surviving spouse may eliminate any taxes in the estate of the first to die; however, additional taxes may be due at the death of the surviving spouse. The marital deduction should be coordinated with each spouse's unified credit.

State death or inheritance taxes may have to be paid in addition to federal transfer taxes. Many state transfer taxes are patterned after the federal tax; however, there are differences, and state taxes may be incurred even in situations in which there is no federal tax.