About the Federal Estate Tax: A 2012 (and 2013) Update

Editor's Note: A major issue in farm transfer, due to high land values, is the federal estate tax. The law, however, is changed often due to a series of political compromises. The following summary was prepared with the assistance of Paige Gentry, JD Candidate, Duke University, 2013.

A fact of life in farm transfer planning is that Congress continues to change estate and gift tax laws. Addressing possible future changes is near impossible, so what follows is a simple summary of the key components of the law for 2012 and how the current law applies to estates opened in 2013.

2012 Estate and Gift Tax, Key Components:

1. Estates worth $5,120,000 or less are excluded from the estate tax. Thus, if your estate is worth less than $5,120,000, it will not be taxed.

2. Estates worth over $5,120,000 will be taxed at a rate of 35%. The 35% tax rate only applies to the amount of the estate that is greater than $5,120,000. For example, if your estate is worth $6,120,000, the estate would only be taxed on $1,000,000 ($6,120,000- $5,120,000), for a tax of $350,000.

3. Using the "portability of exclusion" rule, married couples are allowed to exclude up to $10,240,000 from the estate tax. Under this rule, each spouse can exclude up to $5,120,000. If the first spouse does not use all of his or her exclusion, the surviving spouse can add the remainder to his or her estate (estate must file Form 706).

4. The lifetime gift exemption is $5,120,000, which is equal to the estate tax exemption. Any gift that is made within an individual's lifetime in excess of the annual gift exclusion ($13,000) is deducted from his or her estate tax exemption. Thus, if you gift $1,000,000 in 2012, your estate tax exemption will then be $4,133,000 ($5,120,000 - $987,000). (Note the $1,000,000 in this example is reduced by the allowable annual tax-free gift exclusion of $13,000 [$1,000,000 - $13,000 = $987,000])

5. Individuals who distribute assets to a generation beyond their children will be exempt from the generation skipping tax (GST) if the transfer is less than $5,120,000. The tax rate on amounts that exceed $5,120,000 is 35%.

6. Appreciated property in an estate can receive a step up in basis.

2013 Estate and Gift Tax, Key Components:

1. Estates worth $1,000,000 or less are excluded and will not be taxed.

2. Estates worth over $1,000,000 will be taxed at a rate of 55%. The 55% tax rate only applies to the amount of the estate that is greater than $1,000,000.

3. The "portability of exclusion" rule is extinguished. Any unused exclusion amount cannot be passed to the surviving spouse.

4) The lifetime gift tax exclusion will be $1,000,000. The same unification rules apply as in 2012. However, the annual gift tax exclusion increases to $14,000.

5. The generation skipping tax exemption will be reduced to $1,360,000, with amounts in excess taxed at 55%.

6. The step-up in basis remains in place.

7. As a way to reduce estate tax exposure, under Section 2032A, executors in 2013 can elect to have land in an estate be valued at "use value." Subject to strictly enforced requirements, the value of farmland in an estate may be reduced up to $1,070,000.

Common Methods to Manage Estate Taxes

Regardless of future tax law uncertainty, there are several methods to reduce or eliminate estate tax exposure. Below are several possible strategies:

1. Reducing the valuation of assets at death: Several sections of the tax code allow estates to claim a lower valuation of certain assets. Claiming a reduction in land value with qualified conservation easements (see pg 84) and/or use of Section 2032A (see above) are two possibilities. Placing land in a limited liability company may allow for valuation discounts due to transfer of interest restrictions governing those interests by agreement.

2. Splitting estates: In years past, spouses divided joint property by deed to capture individual exemptions. This can still be done, as can a proper disclaimer of 1/2 property interest by the surviving spouse. Without a trust, however, both distribute property interests directly to heirs as tenants in common, which may not be ideal for continuation of a farm. Jointly owned land placed in a limited liability company can also split land interests.

3. Use of Trusts: In addition to managing efficient distribution of assets, revocable trusts can also be used to maximize marital, individual and GST estate tax exemptions that are no longer portable. Irrevocable trusts can remove property from individual ownership and thus reduce the estate for taxable purposes (see pg 55).