Estate Tax Overview

The federal estate tax is an excise tax imposed on a decedent's privilege of being able to transfer his or her entire taxable estate at death. Internal Revenue Code ("IRC") § 2001(a). The federal estate tax is an indirect tax on the transfer of property rather than a direct tax on the property itself. Because of various exclusions, credits and deductions, only significant transfers of property are subject to the federal estate tax.

Minimizing taxes at death is an important goal for many clients seeking financial and estate planning advice. Although the tax rules applicable to transfers at death are complex, a basic understanding of these rules will help practitioners recognize potential issues and provide sound tax planning advice to such clients.

Generally, a decedent's "gross estate" includes the value of all property owned by the decedent at death and the value of all property in which the decedent had an interest at death. IRC §§ 2031(a) and 2033. This definition is very broad, and includes all kinds of property and property interests, both real and personal and tangible and intangible, wherever situated, to the extent of the interest beneficially owned by the decedent.

Generally, unless the executor elects the alternative valuation method (discussed below), property included in a decedent's gross estate is subject to estate tax based on its fair market value on the decedent's date of death. "Fair market value" is 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 to sell and both having reasonable knowledge of relevant facts. Treas. Reg. § 20.2031-1(b).

IRC § 2010(a) allows a tax credit of the applicable credit amount against a decedent's federal estate tax. The applicable credit amount often is also referred to as the "unified credit." The applicable credit amount is the amount of estate tax that would be generated on a transfer of property in the amount of the "applicable exclusion amount." The applicable exclusion amount often is referred to as a decedent's estate tax exemption.

Basis is the amount used to calculate income tax gain or loss on the sale of property. It usually is the cost of acquiring the asset. Before January 1, 2010 and after December 31, 2010, the basis of property inherited from a decedent usually is the federal estate tax value of the property in the decedent's gross estate. IRC § 1014. If the value at the date of death is lower than the basis of the property, the basis takes a step down to the value on the decedent's date of death. Because property generally appreciates over time, however, there usually is a step-up in basis at death.

Computation of Federal Estate Tax

IRC § 2001(b) describes the computation of a decedent's federal estate tax liability.

a. **<u>Gross Estate</u>**. The first step is to determine what property of the decedent is subject to the estate tax. This property is called the decedent's "gross estate." IRC §§ 2031(a) and 2033 through 2044 describe the various types of property includible in a decedent's gross estate for federal estate tax purposes.

b. **Estate Tax Deductions.** The second step is to determine the total allowable estate tax deductions under IRC §§ 2053-2058.

c. **Taxable Estate.** Next, the decedent's "taxable estate" is determined by subtracting from the decedent's gross estate the total allowable deductions. IRC § 2051.

d. **Tax Base.** A decedent's tax base is the sum of the decedent's taxable estate and adjusted taxable gifts. A decedent's "adjusted taxable gifts" is the total amount of post-1976 taxable gifts made by the decedent that are not otherwise includible in the decedent's gross estate. IRC § 2001(b). Because the estate tax and the gift tax are part of a unified transfer tax system, the decedent's prior gifts are included in the decedent's estate tax computation.

e. **Tentative Tax.** A "tentative tax" is determined by applying the applicable tax rate from the tax rate table in IRC § 2001(c) to the decedent's tax base. IRC § 2001(b)(1).

f. **Reduction for Certain Gift Taxes.** In order to avoid double taxation, the tentative tax is then reduced by gift taxes paid by the decedent on prior post-1976 gifts. IRC § 2001(b)(2).

g. **Estate Tax Credits.** The tentative tax is further reduced by applicable estate tax credits. IRC §§ 2010-2016 cover these credits, which include the unified credit against estate tax, the credit for gift taxes paid on pre-1977 gifts, the credit for tax on prior transfers, and the credit for foreign death taxes.