

FACT SHEET

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Better Estate Planning

FEDERAL ESTATE AND STATE INHERITANCE TAXES

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Estate Planning attempts to create an equitable compromise between minimizing the amount of taxes due, distributing the property as desired to the designated heirs and assuring a financial source of security.

This fact sheet on Federal Estate and State Inheritance Taxes was prepared by Eugene M. McElyea, L.L.B., College of Business, Texas A&M University and consultant to the Texas Agricultural Extension Service program for this series of fact sheets on Estate Planning.

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Government at every level must have money to perform essential services. Taxes which supply these funds are derived from a broad range of sources. In addition to raising operating money, government has on occasion used its taxing power to accomplish social purposes. Taxes on certain dangerous weapons have been enacted to prevent widespread ownership of these weapons rather than for the revenue such taxes provide.

Taxing property at death began not as a revenue producing measure, but in order to lessen the bad economic effects of wealth being owned and controlled in small family or other closely-knit groups. In order to break up large concentrations of wealth, government devised Estate Tax and Inheritance Tax laws. Notwithstanding the original purpose of these laws, a substantial and regularly increasing dollar inflow from these tax sources has made death taxation a primary revenue source in America today. These laws can have a substantial economic impact on even an estate of modest holdings and

without proper planning, the impact on large estates can be devastating.

Death taxes are payable only after death. Since these taxes are not paid on a regular basis like annual income tax, a person may live many years unaware of the broad range and scope of these taxes. Do not wait for involvement in the estate affairs of another in order to gain familiarity with death taxes. That has often proven to be a costly and unpleasant experience.

The federal estate tax is not a tax on the estate property directly, but an excise tax on the owner's right to *transfer* the property at death. Transfers to charity, however, are exempt from the tax. State inheritance tax is based upon the right of one to *receive* a deceased person's property and it varies according to the kinship of the beneficiaries to the deceased person. The federal gift tax is a tax on lifetime transfers. This tax was enacted to prevent gifts which would in effect defeat the estate tax. It, too, is a tax on the donor's right to *transfer* his property to another.

FEDERAL ESTATE TAX

The federal estate tax is easily understood. In computing the tax, one must first determine the amount of the deceased person's gross estate.

The gross estate consists of all property which the deceased owned at death and the value of that property which the deceased gave away in contemplation of death within the 3-year period before death or sold for something less than full value. Also included in the gross estate would be property partially given away before death by the deceased person over which he continued to exercise use, control and enjoyment during life.

A married person's gross estate in Texas would include only a one-half portion of the community property. The surviving spouse owns the other

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half outright. That portion is not taxed until the surviving spouse dies. The deceased may also give up to one-half of his separate property to his surviving spouse tax free. Such gifts of separate property qualify for the deduction known as a marital deduction. It is more widely used as a tax saving device in non-community property states.

Once the gross estate has been determined, that amount is subject to certain deductions. Among the deductible items are estate administration expenses including attorney's fees and court costs. Funeral costs and debts are deductible items. Charitable gifts may be deducted for the full amount of their value. There is a standard deduction of \$60,000 allowable in every case. After all deductions are taken, the amount left is the net taxable estate. This figure determines the tax amount.

An estate of \$60,000 or less would not be taxable because the standard deduction of \$60,000 would reduce the net taxable estate to zero. A married couple who together have a community estate of \$120,000, would have no tax when the first spouse dies. One-half of the \$120,000 (\$60,000) belongs to the surviving spouse outright as his share of the community property and is not subject to tax. The standard deduction would then reduce the amount of the net taxable estate to zero.

The situation would be quite different for an unmarried person with an estate of \$120,000 since there is no surviving spouse with whom ownership is shared. The standard deduction would reduce the amount subject to tax to \$60,000. Assume \$10,000 in other deductions. The net taxable estate would be \$50,000. Tax on that amount at current rates would be \$7,000.

The rates for federal estate tax are progressively higher on larger amounts. It is therefore not uncommon in larger estates for disputes to arise over the value of property belonging to the deceased, whether or not the deceased person made a gift before death in an attempt to avoid taxes, and whether or not the expenses represented by deductions are reasonable. It can be seen that in any estate numerous questions about tax liability are likely to arise.

The federal estate tax is payable in cash 15 months after death. If cash is not available for this purpose, it might become necessary to sell property in the estate to pay the taxes. Wise estate planning considers the need for cash at death. When circumstances do force a sale of property at an inopportune time, it is hard to calculate the loss. The taxes in such instances may be only a part of the cost one's estate must pay for lack of proper estate planning.

TABLE 1. FEDERAL ESTATE TAX RATES

Taxable Estate		Tax	Percent	Of excess over
From	To			
\$ 0	\$ 5,000	\$ 0	3	\$ 0
5,000	10,000	150	7	5,000
10,000	20,000	500	11	10,000
20,000	30,000	1,600	14	20,000
30,000	40,000	3,000	18	30,000
40,000	50,000	4,800	22	40,000
50,000	60,000	7,000	25	50,000
60,000	100,000	9,500	28	60,000
100,000	250,000	20,700	30	100,000
250,000	500,000	65,700	32	250,000
500,000	750,000	145,700	35	500,000
750,000	1,000,000	233,200	37	750,000
1,000,000	1,250,000	325,700	39	1,000,000
1,250,000	1,500,000	423,200	42	1,250,000
1,500,000	2,000,000	528,200	45	1,500,000

STATE INHERITANCE TAX

Texas like many other states has a state inheritance tax. While it applies to estates of somewhat smaller value than does the federal estate tax, its rates are not as large. By comparison, the state inheritance tax is less severe than the federal estate tax.

All property one owns at death or has given away for something less than full value within a 2-year period prior to death as well as property over which he maintains control is taxable for state inheritance taxes. Texas allows a tax exemption on the first \$40,000 of life insurance proceeds. All of the life insurance proceeds on policies one owns at death are taxable by federal authorities. The fact that this money is paid to a named beneficiary other than the insured's estate is not the point. Policy ownership is the deciding factor in taxing these proceeds.

Texas Inheritance Tax is computed on the basis of the value received by a beneficiary. The tax rate on each bequest varies depending upon the kinship of the beneficiary to the deceased.

The law divides possible beneficiaries into five classes (A through E). Bequests are tax exempt according to the following formula:

CLASS A—Bequests to husband, wife, child, lineal descendants, sons-in-law, daughters-in-law.

Exempt to the extent each bequest to each individual does not exceed \$25,000.

CLASS B—Bequest to the United States to be used in Texas.

Exempt to the extent such bequest does not exceed \$25,000.

CLASS C—Bequests to brother, sister or direct lineal descendant of brother or sister.

Exempt to the extent each bequest to each individual does not exceed \$10,000.

CLASS D—Bequests to uncle, aunt or direct lineal descendant of an uncle or aunt.

Exempt to the extent each bequest to each individual does not exceed \$1,000.

CLASS E—Other bequests.

Exempt to the extent each bequest to each individual or organization does not exceed \$500.

Charitable bequests have not always been exempt in Texas from inheritance tax. The law has been changed and charitable gifts now exempt under federal laws qualify for state tax exemption as well.

The rate of taxing beneficiaries according to their respective classes follows:

CLASS A&B—

\$ 25,000 to \$ 50,000	1%
\$ 50,000 to \$ 100,000	2%
\$100,000 to \$ 200,000	3%
\$200,000 to \$ 500,000	4%
\$500,000 to \$1,000,000	5%
Over \$1,000,000	6%

CLASS C—

\$ 10,000 to \$ 25,000	3%
\$ 25,000 to \$ 50,000	4%
\$ 50,000 to \$ 100,000	5%
\$100,000 to \$ 250,000	6%
\$250,000 to \$ 500,000	7%
\$500,000 to \$ 750,000	8%
\$750,000 to \$1,000,000	9%
Over \$1,000,000	10%

CLASS D—

\$ 1,000 to \$ 10,000	4%
\$ 10,000 to \$ 25,000	5%
\$ 25,000 to \$ 50,000	6%
\$ 50,000 to \$ 100,000	7%
\$100,000 to \$ 500,000	10%
\$500,000 to \$1,000,000	12%
Over \$1,000,000	15%

CLASS E—

\$ 500 to \$ 10,000	5%
\$ 10,000 to \$ 25,000	6%
\$ 25,000 to \$ 50,000	8%
\$ 50,000 to \$ 100,000	10%
\$100,000 to \$ 500,000	12%
\$500,000 to \$1,000,000	15%
Over \$1,000,000	20%

It is clear that the impact of inheritance tax can be lessened or even eliminated depending upon

how one distributes property. Good estate planning means distributing one's property at minimum cost, but planning to avoid taxes entirely can often trap people into arrangements that are undesirable and unsuitable. Good planning does not necessarily imply an estate will pass tax free.

Inheritance tax and estate tax are both due and payable at the same time. The office of the Comptroller of Public Accounts is the collector of inheritance taxes while federal estate taxes are collected by the Internal Revenue Service of the U. S. Department of the Treasury.

Proper estate planning can often lessen or eliminate entirely the impact of state inheritance tax. This is accomplished by dividing the larger estate into numerous smaller bequests to several persons rather than one large bequest to one individual. For example, there is no state tax on an estate of \$150,000 if it is divided equally among a surviving spouse and five children. As Class A beneficiaries they can each take \$25,000 tax free. Giving it entirely to a surviving spouse would subject \$125,000 to state inheritance tax. While it is important to consider when taxes might occur, in making distributions one must necessarily give greater weight to the needs of those receiving the estate. Numerous small bequests as suggested here might defeat taxes, yet they might also defeat the security that surviving loved ones badly need. A person who has a surviving spouse and numerous lineal descendants can potentially give away a very large estate to these Class A beneficiaries with no tax whatever. It is still poor tax planning if this distribution plan is not what a person really prefers.

Lessening estate taxes is accomplished by channeling it to one's survivors in ways that do not subject the same property to multiple taxation. Property is taxed when it is earned (income tax); it is taxed when the first spouse dies (estate tax) and if the property has all passed to the surviving spouse, it is again taxed (another estate tax) when that spouse dies. It is this possibility of double taxation which taxes most heavily the natural inclination of many husbands and wives to protect the survivor of them by giving the survivor a large bequest. Estate taxes are heaviest when the second spouse dies since that spouse then owns entirely what was once the community estate, half of which escaped taxation when the first spouse died. This tax impact can be particularly damaging when both spouses die within a relatively short period. That situation doubles the costs and assumes maximum taxes when no planning has been made.

When one considers that the federal estate tax taxes *everything* one owns, it is essential that a prudent person inventory his estate. Persons with

land may be "land poor." The cash flow may increase slightly from year to year, yet inflation has substantially increased the value of farm land. This land is taxed at its current actual value and without sufficient cash to pay these taxes at death, it could become necessary to sell the family land holdings. Other property includable in the gross estate for estate tax purposes are life insurance proceeds. This is true even though the insurance is paid to a beneficiary if the deceased insured "owned and controlled" that policy during life.

Steps to proper planning are just one more part of the good business practices which should

prevail in proper farm or ranch enterprise management. Avoid now the costly erosion that occurs through neglect of proper estate and tax planning.

This publication is designed to provide accurate and authoritative educational information in regard to the subject matter covered.

It is distributed with the understanding that the publisher is not engaged in rendering legal services. Attorneys should be contacted for legal advice.

SUGGESTED READINGS

Listed below are additional Extension fact sheets on Estate Planning.

- L-950 The Importance of a Will in a Texas Estate
- L-951 Texas Laws on Descent and Distribution
- L-952 Community and Separate Property in Texas
- L-953 Costs of an Estate in Probate
- L-954 Charitable Gifts
- L-956 Gifts and Trusts: Effective Estate Planning