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EFFECTIVE ESTATE PLANNING

Changes in federal and North Carolina Estate Tax Laws

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Introduction

The March/April 1998 *NC State Economist* described income tax changes affecting North Carolina taxpayers due to the Tax Relief Act of 1997. The Tax Relief Act also includes changes that affect estates and estate planning by individuals. This report examines the most far-reaching changes and provides estate-planning strategies for North Carolinians.

Unified Credit

The unified credit (the amount used to offset federal estate tax) was set at $192,800 in 1987 and was not increased to keep pace with inflation for the next ten years.The credit value was equivalent to an exclusion of $600,000 (referred to as the *tax-free* estate) from the gross value of the estate. The Tax Relief Act of 1997 (TRA) included legislation that increased the unified credit to $202,050 and thus the equivalent exclusion amount. In 1998 if an estate has a net value of $625,000 or less, the estate tax is $0. The exclusion amount increases each year to a total amount of $1,000,000 by January 1, 2006 (Table 1).

Gifts given to individuals enjoy an additional annual exclusion of $10,000 per-year, per-donor. TRA increases this gift exclusion annually. The increase is linked to an inflation index and adjusted to the nearest $1000 over time. Sometimes a gift is greater than the exclusion amount. If the gift is greater than the $10,000 annual gift exclusion, the donor may wish to use the unified credit to escape gift tax. If, for example, a house and property given to a child has a fair market value greater than $10,000, a gift tax return is necessary, and tax is due on the portion of the gift that exceeds $10,000. Since the unified credit will offset the gift tax liability in the same way as it offsets the estate tax to the maximum applicable limit, the taxpayer can use a portion of his/her unified credit to eliminate the tax. The gift tax rate and the estate tax rate are the same. Using the credit for gift purposes during a donor's lifetime reduces the unified credit by the amount used. In turn, the estate value that will pass tax-free at death is also reduced.

Table 1. Estate Size that is Tax Free Represented by the Applicable Exclusion Amount

Year of Death or Gift	Applicable Exclusion Amount
1998	$625,000
1999	$650,000
2000 and 2001	$675,000
2002 and 2003	$700,000
2004	$850,000
2005	$950,000
2006 and thereafter	$1,000,000

N.C. Estate Exclusion Amount

North Carolina has an exclusion allowance similar to the federal allowance. Calculations for state and federal estate taxes are separate. For Class A beneficiaries (children, parents, spouses), the North Carolina inheritance tax credit is $33,150. This applies to estates created after January 1, 1997. This credit increases the gross value of an estate that must file an inheritance tax return from $450,000 to $600,000. If the gross value of the estate is $1 or more, an estate tax return must be filed by Class B (siblings, aunts and uncles, nieces and nephews) and Class C, (all others) beneficiaries. These are the only major changes in North Carolina inheritance tax laws and regulations in recent years.

Qualified Family Owned Business

Much of the debate that created changes in estate taxes in the Tax Relief Act of 1997 involved extra estate tax relief for family-owned businesses that are passed on and continue after death of the primary owner(s). The cash demand of paying estate taxes often requires increased debt or the sale of business assets that jeopardizes the ability of the business to continue.

In response to this, Congress included a dramatic special provision that raises the exclusion amount to $1.3 million for *Qualified Family Owned Businesses* (QFOB), effective January 1, 1998. This extra exclusion (i.e., the amount above the regular exclusion in Table 1) is the QFOB exclusion. The regular exclusion plus the QFOB is set at a total of $1.3 million which does not change over time. Technically, this puts a large majority of family businesses beyond the reach of estate taxes, particularly where more than one individual has ownership. For example, a husband and wife owning a family farm business could leave $2.6 million in their estates tax-free to children continuing to operate the farm business.

In its simplest conceptual form, the QFOB provision would seem to be a major tax break and planning device for estates having family business assets. However, the QFOB statute is unbelievably complex, partly because it contains burdensome qualifying provisions to prevent investors, as distinguished from family owner-operators, from qualifying. In addition, the language of the statute is unclear in places, which will require technical corrections and/or court case interpretations. The practical actual use of the QFOB exclusion remains in doubt at this time.

Nonetheless, we can examine the major provisions of QFOB to determine intent and potential use as an estate-planning tool. A detailed look at all the requirements is not possible here, and readers are encouraged to seek professional legal counsel before incorporating it into their estate tax planning.

Major requirements for using the QFOB exclusion are:

(1) The decedent must have been a United States citizen or resident at the time of death.

(2) The value of the QFOB interests must exceed 50 percent of the total adjusted gross estate.

(3) The decedent or a member of the family must have owned and materially participated in the QFOB for at least five of the last eight years preceding the decedent's retirement, disability, or death. This material participation cannot be through a third party such as a property manager or other agent.

(4) The QFOB must be a closely held business.

(5) QFOB assets can not include cash or marketable securities that exceed necessary day-to-day working capital. Passive assets, those which produce interest,dividends, rents, royalties, annuities, and other types of passive income, cannot be included. Land or buildings that produce cash rent, or share rents without material participation of the owner are not eligible for the QFOB exclusion. This criteria may prove to be a significant problem for using the QFOB in many estates.

(6) The QFOB interest must pass to or be acquired by qualified heirs, i.e., spouse, ancestor, lineal descendent and their spouse, or an individual employed by the business for at least ten years before death.

Establishing eligibility before death, however, is only half the battle. There is also a set of rules in effect after death to avoid *recapture* of the tax reduced by the QFOB exclusion. Each qualified heir (or qualified members of his/her family) must materially participate in the QFOB for at least five of any eight-year period within ten years following death. (Simple, huh?) In other words, the business must remain owned, operated, and managed by the family for a minimum length of time after death. If a qualified heir disposes of his/her interest in the QFOB to anyone other than family members during this period, part of the QFOB tax savings must be recaptured. The same is also true if they no longer materially participate in the business. The obvious problem that arises is the sale of the property outside the family. The less obvious problem is the rental of the property, which still needs clarification. This constitutes a dangerous tax trap for unwary heirs.

Special Use Valuation of Land

Since 1976, an optional special procedure for valuing land at its *use* value rather than fair market value in determining the taxable estate has existed. Eligibility rules are similar to those for QFOB. Again, the most difficult rules to follow are material participation, rent, and qualified heirs, especially in the ten- to fifteen-year period following death. There is no substantive change in the TRA of 1997 to special use valuation other than to slightly broaden the ability of a surviving spouse or lineal heir to cash rent the inherited land to other family members without triggering the recapture tax.

Installment Payment of Federal Estate Tax

Since 1977, federal estate tax is payable in installments at a low interest rate for the portion of the tax attributable to closely held business assets in the estate. The TRA of 1997 reduces the interest rate from four to two percent on the amount of the deferred tax arising from the first $1 million of the taxable estate (i.e., the amount above the regular exclusion and any QFOB exclusion).

Marital Exclusion and Property Ownership

Assets transferred to the surviving spouse at death are tax free regardless of the amount. While this is an obvious tax advantage in the short run, it has long-run disadvantages that necessitate estate planning for the surviving spouse including the review and evaluation of property ownership. Property ownership and who may reap the income benefits from that property is important in estate planning to reduce the estate tax paid on the two marital estates. The objective is to protect the maximum tax-free estate of $1,250,000 ($625,000 for each spouse in 1998). For example, if the total estate of a married couple is $1,250,000 and all assets are in joint tenancy, the entire property transfers to the surviving spouse when the first spouse dies. This estate will transfer tax-free (federal) because of the marital exclusion. Now the problem is that the surviving spouse has an estate of $1,250,000, and $625,000 will be subject to estate taxes upon his or her death. The federal estate tax on $625,000 is approximately $246,250. This amount can be saved with effective estate planning. (There is an additional amount of N.C. inheritance tax as well.) It is advisable to contact an attorney knowledgeable in estate planning to maximize this benefit. This example is simple and is used to illustrate what may be done with estate planning to save substantial amounts of tax liability during a time of stress for remaining family members.

Ownership of property at the time of death will determine the amount of estate (inheritance) tax to be paid. Careful planning that includes who will inherit property and how the property is held will determine the final tax bill. A word of caution—estate tax-planning done only to eliminate or decrease the tax bill may be for naught if your intentions for providing for the surviving spouse and other loved ones are not met. This part of estate planning is often the most difficult; that is, deciding who gets what. To accomplish these goals, tax may have to be paid. Again, consult a qualified estate attorney to assist in planning. Once the plan is in place, review every two to three years to ensure all goals are current and can be met in case of death.

Correction

The March/April, 1998 *NC State Economist* reported the Life Long Learning Credit allows any educational expense to be used toward the credit. This is incorrect. The Life Long Learning Credit follows the same regulations as the Hope Credit; namely, only fees and tuition qualify as expense under this credit.

The July/August 1998 issue of the North Carolina State Economist will describe Intellectual Property -- what it is, why it is important, and how it can beneft you.

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