



Simply put, the U.S. federal estate tax is levied on the transfer of property when someone passes away. Similar to income tax, the estate tax is progressive with rates increasing as the value of the taxable estate increases. While the maximum rate has changed over the years, it has generally been 35%-55% of the taxable estate. This may seem to be high, but it is substantially lower than the 77% rate that was in effect from 1941 through 1976.

While there are extensive laws that govern the estate tax, there are a few that are important to note. First, a portion of your gross estate will be exempt from the estate tax. The exemption amount has changed numerous times, but in recent years has fluctuated between \$1,000,000 and \$5,000,000 per person. Second, there is an unlimited marital deduction, so no estate tax applies for any amount transferred to your spouse. Third, there is an estate tax charitable deduction for amounts transferred at death to qualified charitable organizations, private foundations, etc. And finally, for those who think they can simply give away their wealth prior to their death to avoid taxation, there is also a federal gift tax that closely mirrors the estate tax. The tax applies to gifts that exceed the annual allowance (currently \$13,000 per recipient per year) and will only be levied after a taxpayer has made taxable lifetime gifts that exceed the available lifetime gift tax exemption (currently \$5,000,000).

## The Federal Estate Tax - A Brief History

Following the outbreak of the Spanish-American War of 1898, a volatile debate erupted in Washington D.C. over a federal estate tax. Proponents claimed that a tax on the wealthy to help pay for necessary expenditures, including defense of the country, would curb unrestrained capitalism and the dynastic accumulation of wealth. Opponents argued that a tax passed at the time of death fostered a disincentive to create wealth through small businesses and was inherently unfair. U.S. Senator John Sherman regarded inheritance from father to son so natural that it did not seem right to tax it. In the end, Congress passed the War Revenue Act of 1898, which

included a progressive estate tax, and Republican President William McKinley signed it into law.

It seems that not much has changed over time, given that Washington is still debating the estate tax, with opposing parties using the same arguments to advance their positions. In fact, the federal estate tax has been a contentious issue throughout our history. After the first tax was created in 1862 to help finance the Civil War, some form of estate tax has been instituted and subsequently repealed four times. The estate tax that we have today came out of legislation passed in 1916 and has gone through numerous changes, including exemption amounts, tax rates, and the introduction of the federal gift tax. The most recent estate tax ended in 2010, only to come back in 2011 with higher exemption amounts and lower tax rates. So while the debate continues, if history is any indication, those with substantial wealth in this country should expect, and plan for, estate taxes being levied when they pass away.

## Planning for the Estate Tax

The estate tax uncertainty has made planning difficult. During 2010, the year without an estate tax, no less than four individuals with gross estates over one billion dollars passed away. These families seemingly hit the estate tax lottery. Then, the 2010 Tax Relief Act, which the President signed into law on December 17th, made dramatic, temporary changes to the federal transfer tax system. This left the executors of estates for those who passed away in 2010 with two options: pay the federal estate tax as if the new laws were applicable or operate under a carryover basis regime that could lead to capital gains taxes in the future. Adding to the confusion, when the 2010 Tax Relief Act expires on December 31, 2012, we will revert back to the estate tax laws that were in effect in 2001. That will surely lead to the next heated debate, probably with the same arguments used in 1898, to decide to future of estate taxes—extend, amend, or allow the estate tax to lapse?

Even though at times it may seem like a moving target, affluent families need to plan for this tax.

History is replete with accounts of families who were forced to sell their business, farm, or other property that had sentimental value in order to generate the funds necessary to pay the federal estate tax.

### The Liquidity Issue

Many large estates are made up of non-liquid assets such as closely-held business interests. In a survey of over one thousand family owned businesses, 72% of owners stated that estate taxes would threaten the survival of their business and 41% claimed that estate taxes would require selling all or part of the business<sup>1</sup>. While there are many techniques for reducing exposure to, and deferring payment of, estate taxes, the number one issue that estates face is liquidity. Where will the funds come from to pay a tax of 35%, 55%, or even 70% of the value of the estate when it is largely made up of a business interest?


If the estate does not have sufficient liquidity the executor/executrix will have two choices: sell something or borrow the money. When the estate borrows money, it will eventually have to repay the loan and will still probably need to sell something. So it becomes a matter of which asset(s) should be sold at your death and at what cost. Selling the business itself defeats the purpose because it removes control of the business from family members. It may also cause job losses for employees who were partly responsible for its success. And it may take substantial time to find the right buyer. Selling other assets may have similar consequences. For example, it may be difficult to sell commercial real estate when the real estate market is down and the estate may then incur property management and insurance expenses until a successful sale. Other assets may need to be sold in a fire sale for pennies on the dollar. Beyond simply earmarking specific assets to be sold, what are the other options for an illiquid estate?

### Planning for the Estate Tax - Creating Liquidity

The best way to make sure that estate taxes don't force the sale of a business interest is to create liquidity while the owner is alive. This will require a repositioning of current assets and may generally be accomplished in one of two ways - by selling assets and investing the proceeds or buying life insurance. The chart below provides an introduction to the advantages and disadvantages of these two options:

	Sell Asset(s)/ Invest Proceeds	Life Insurance
Income/Capital Gains Tax	The sale may trigger capital gains tax.	✓ Avoids the tax liability associated with selling assets.
Investment Options	✓ Unlimited investment options.	Limited investment options.
Timing Risk	Timing of sale may be inappropriate. If death occurs prior to life expectancy, it will be difficult to generate sufficient liquidity to pay estate taxes.	✓ Funds are available exactly when needed, avoiding the issues associated with premature death.
Creditor Access	A substantial liquid "side-fund" is an attractive target for potential creditors.	✓ May be established to protect the policy from creditors.
Investment Risk	Subject to investment risk.	✓ Minimal exposure to investment risk.
Access to Funds	✓ Flexibility—even though assets are "earmarked" to pay estate taxes, funds remain accessible.	Limited access to funds.
Diversification	Building a "side-fund" with a value equal to approximately half the value of the gross estate may require divesting assets or investment opportunities that may be appealing.	✓ Assets/funds not used to pay premiums may remain invested as before for maximum diversification.
Performance	✓ Will vary depending on level of risk taken.	✓ Competitive internal rate of return on death benefits which are received income tax free.

The federal estate tax is an important component of your overall estate planning strategy and considerations for the most effective, appropriate



methods of creating liquidity are complex, as illustrated in the above chart. Parker, Smith & Feek's experts in estate planning are available to help you understand your options and create an effective plan for the federal estate tax.

By John Frazier. Vice President

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1 Astrachan, Joseph H. and Roger Tutterow. "The Effect of Estate Taxes on Family Business: Survey Results." Family Business Review: Fall 1996.