COMBINED FEDERAL-STATE DEATH TAX IMPLICATIONS FOR NONINDUSTRIAL PRIVATE FOREST LANDOWNERS IN THE UNITED STATES.

by

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Thesis submitted to the Faculty of the

Virginia Polytechnic Institute and State University

in partial fulfillment of the requirements for the degree of

Master of Science

in

Forestry

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June, 1986

Blacksburg, Virginia

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(ABSTRACT)

Generally, death taxes are a social instrument used to break up large quantities of wealth in this country. They are intended to act as a pressure relief valve and prevent wealth concentration in the hands of a small number of individuals. Because the objectives and goals of individuals may be quite different from society, forest landowners are one group who face potentially serious problems due to death taxes. Illiquidity, low cash flows and credit problems can cause difficulties for heirs of forest land.

Death taxes are examined from a historical, legal and economic perspective. Specifically, this study focuses on the implications of both federal and state death taxes on private forest landowners. Particular attention is paid to changes which have occurred because of the 1981 Economic Recovery Tax Act (ERTA). Provisions which are designed to give estate tax relief to nonindustrial private forest landowners are also examined.

Study results show that federal death taxes are not reducing wealth concentration. It is also shown that through proper planning, estate taxes at the federal level can be eliminated. The state death tax burden can be substantial however, and must still be considered, even though many states have substantially eased their laws following ERTA. Proper planning, particularly when forest land is involved, should include both spouses. Finally, note that special provisions designed to give estate tax relief to farm and woodland owners have fallen short of this goal, primarily because of the complex regulations which are involved.

ACKNOWLEDGEMENTS

I am indebted to many people for their help in preparing this thesis. First and foremost, I would like to thank my chairman, Dr. Harry L. Haney, Jr., for his friendship, guidance and allowing me flexibility in designing this project. My other committee members, Drs. Harold W. Wisdom and W. David Klemperer deserve thanks for helping me with the theoretical details and making sure I kept my value judgements to a minimum.

I would especially like to thank the U.S. Forest Service, Southern Forest Experiment Station for funding this project. Dr. William Siegel, although not a committee member, contributed greatly to the ideas presented in this thesis for which I am grateful.

I would also like to thank my mother Carolyn, sister Rebecca and the rest of my family for their encouragement throughout my study. Many thanks to my fellow graduate students in room 200 for their friendship and motivation. Cathy Barker deserves special thanks for her excellent typing. The people of Harvest Baptist Church, especially Dave and Debbie Watson, helped me keep life in perspective. Most of all, it was by the grace of the Lord Jesus that I was able to reach my goals.

Finally, I would like to dedicate this work to my father who died in 1974. His integrity and determination constantly inspired me throughout my college years.

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CHAPTER 1. INTRODUCTION

Private nonindustrial forest lands in the United States constitute an important element of the nation's future timber supply. These holdings comprise 58 percent of the commercial forest resource and represent approximately seven and a half million ownerships (Plochman 1983).

Survey results have shown that the typical forest landowner is over 50 years of age (Birch 1983). These owners, along with their families face potentially serious problems when attempting to transfer their holdings either by gift or at death. Over the past decade, rising timberland values have often reflected inflationary increases and demand for alternative land uses rather than higher production levels in forestry. These higher values, when coupled with federal and state death taxes may create a heavy financial burden.

Several recent studies have examined the relationship between death taxes and farm and forested properties. Tedder and Sutherland (1979) showed that planning was necessary in order to fund estate taxes. Harle and Boehlje (1978), identified estate planning models. Reinders, Boehlje and Harle (1980) developed an analytical model for determining the optimal marital deduction. Howard (1982, 1985) discussed the impacts of different business organization forms on estate and income tax liabilities of nonindustrial forest landown-

ers. Gardner, Olson, Haney and Siegel (1984) demonstrated how the total death tax burden (state plus federal) can be reduced by the election of special options in federal law relating to agricultural and forested land. These authors mainly emphasized federal provisions without incorporating state death tax considerations.

Olson and Haney (1980) and Olson, Haney and Siegel (1981) analyzed the interaction of federal death tax legislation with state death tax statutes. Since then, the 1981 Economic Recovery Tax Act (ERTA) has made numerous changes in the federal death tax statutes. Many states have followed by making changes in their death tax statutes. Most of these changes incorporate, to some extent, those changes made at the federal level. Consequently, much of the information used in previous studies is outdated.

OBJECTIVE

The objectives of this study are:

(1) To determine the number of states that have changed their tax system since the 1981 Economic Recovery Tax Act (ERTA).

(2) To determine various tax liabilities given different planning strategies and state tax systems.

(3) To examine special provisions aimed at preserving forest and agricultural land in the federal and state death tax codes.

(4) To briefly review theoretical literature concerning death taxes.

(5) To review the history, constitutionality and structure of the federal transfer tax system.

METHODOLOGY

Each of the 50 states were re-surveyed to determine how many changes have occurred since the original work done by Olson, Haney and Siegel (1981). Each state's revenue department, or taxing authority, was sent a letter asking them to furnish information on the current death tax statutes, applicable tax forms and pending legislation that affects forestry and agricultural land in their state. Attention was given to tax statutes that have changed in response to ERTA. Expected changes in the 1984 Tax Reform Act and the 1984 Deficit Reduction Act were also incorporated into the analysis. Information received from the states was supplemented by a review of annotated statutes at the Washington and Lee University Law Library in Lexington, VA.

The analysis specifically models federal-state interaction on:

(1) Death tax forms and rates;

(2) Marital deduction, exemption or credit.

(3) Special-use valuation.

(4) Tax payment deferrals, delays and extensions; and

(5) Special provisions applicable to forest land and timber.

Information from these areas were used to analyze the impact of one death on a typical family of husband, wife and two children. The value of the taxable estate was adjusted to simulate the impact of transferring assets at death valued between $600,000 and $1,200,000; $1,200,000 and $3,000,000; and over $3,000,000. These three zones cover the range of values found in taxable estates containing forestland. The study used 1987 as the base year in order to fully incorporate the provisions of ERTA. Since this legislation will be fully phased in by 1987, all major revisions by the states should be enacted by this date[1] (Commerce Clearing House 1981).

A further analysis was conducted to determine the tax liability at the second spouse's death. This was accomplished through a present value analysis. The spouses objective was to minimize the present value of estate taxes subject to meeting other family goals. In the first case, property was owned jointly by both spouses with rights of survivorship. The husband dies first, and the surviving

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[1] The tax reform act of 1984 postponed the final phase-in until 1988 of the 50% maximum rate.

spouse acquires all property. In the second situation, all the property was held in the husband's name. He dies first, leaving $600,000 to his wife and the remaining property in a trust fund, income to the surviving spouse for life, remainder to the two surviving children. In the third model, property was held in the husband's name and he will die first without leaving a will (intestate). In all three situations, it is assumed that the wife dies ten years after the husband. This avoids complications caused by credits on previously taxed property at the state level (this is not relevant at the federal level due to the unlimited marital deduction). The analysis will use three specific northeastern states since the tax liability at both deaths depends on state statutes. The model emphasizes the need to incorporate both federal and state laws in an estate planning process.

The third phase of this project examines special-use valuation and deferral and extension provisions at both the federal and state level. By examining these provisions, regional variations in death tax laws are examined. This section also deals with valuation techniques used by the Internal Revenue Service (IRS). An example illustrates the various methods.

FORMAT

The results of this study are divided into three parts. The first section of this thesis deals with the theoretical and societal implications of death taxes, along with the structure of both federal and state transfer taxes.

The second section examines the combined federal-state death tax implications for a nonindustrial private forest landowner (NIPF) under three different tax systems. The initial model examines the total tax levy at the first spouse's death, and focuses on the southern region.

The second model considers the total federal-state tax burden through two deaths. Three different pre-death ownership strategies were examined. Different death tax systems were analyzed using the various ownership strategies. Results are shown in a present value framework. This section uses the northeastern states as the study area.

The third section of the thesis deals with two special forestry provision--special-use valuation and deferral and extension--which are available at the federal, and in some cases, the state level. I will focus on specific federal and state provisions which deal with both these areas. The major portion of this section deals with valuation techniques and the complications which are encountered when establishing a special-use value.

CHAPTER 2. ECONOMIC AND SOCIETAL ARGUMENTS

Before proceeding further with the technical aspects of our current death tax system, I will briefly examine several well known economists' views about death taxes. In addition, I will review present economic theory and revenue statistics dealing with death taxes. An understanding of the economic history, theory and revenue statistics helps explain societal impacts brought about by these taxes.

PAST ECONOMISTS VIEWS

Taxes on the transfer of wealth have been in existence for quite some time. The first evidence is traced to the Roman Emperor Augustus, who established an inheritance tax in Rome in 6 A.D. (West 1908). Although most economic historians point to this as the earliest evidence of death taxes, others feel that they might have constituted a part of the fiscal system of Egypt during the second century B.C. and may have actually existed five centuries before (Handy 1922). Arguments against inheritance taxes date back to the Emperor Trajan when Pliny the younger argued against levying death taxes on close relatives (West 1908).

Death taxes are based on the theory that individuals enjoy a life interest in property earned or acquired which

upon death, the state has a right to claim (Handy 1922). Modern economists have argued both for and against death taxes. Adam Smith stated in Wealth of Nations that inheritance taxes violated his first canon of taxation that "the frequency of transference not being always equal in property of equal value". He also felt that they "tend to diminish the funds destined for the maintenance of productive labor" (West 1908). Ricardo added to Smith's objections by stating that "governments should never levy taxes on capital" (West 1908). Ricardo's five points against levying death taxes were:

(1) Death taxes act as a deterrent to industry and the habit of saving.

(2) They absorb funds for the cost of government which should be used for industrial development.

(3) There is no incentive for a person to build up a prosperous business, if that business is to be taxed out of existence when it passes to the next generation.

(4) Death taxes are taxes upon widows and orphans.

(5) Death taxes are levied at a time when the estate is disorganized, due to the proprietor's death, and therefore it is least able to bear the burden (Handy 1922).

J.B. Say agreed with Ricardo, but argued that the inheritance tax "was one of the least difficult of all taxes to pay", and

so concluded that it would be injurious only when carried to excess (West 1908).

There have also been many arguments for a heavy death tax levy. Jeremy Bentham strongly supported the idea that there was no reason for intestate succession among relatives outside of the immediate family. However, he maintained that the proposal to abolish intestate succession except among near relatives was entirely different from a succession tax (Handy 1922). John Stuart Mill advocated progressive inheritance taxes and "the abolition of collateral inheritance and a limitation of the amount which any one should be allowed to take either by inheritance or bequest" (West 1908). He also "thought to restrict what any one should be permitted to acquire by bequest or inheritance" (West 1908). It is surprising that Andrew Carnegie, one of the nation's wealthiest individuals, strongly supported the idea of restricting inheritances. In a New York lecture Carnegie declared that "the almighty dollar bequeathed to children is an almighty curse. No man has a right to handicap his son with such a burden as great wealth" (West 1908). He also stated in the Gospel of Wealth that "the person who leaves his son enormous wealth generally deadens the talents and energies of the son and tempts him to lead a less useful and less worthy life than he otherwise would, seems to me capable of proof which cannot be gainsaid" (West 1908).

In summary, death taxes have been widely debated in the early economic literature. Arguments against death taxes have generally been made on the impact the taxes have on capital formation. The case for a progressive death tax levy is usually on the grounds of societal benefits brought about by wealth distribution.

PRINCIPLES OF TAXATION

Taxes are a form of cost-sharing used to finance government activities. The two major principles used in evaluating taxes, or cost sharing, are the "ability to pay" and the "benefit approach" (Hyman 1979).

The ability to pay principle links the tax share to economic capacity and requires decisions to be made about "an equitable distribution of the tax burden among citizens" (Hyman 1979). This means that people in equal positions should pay equal taxes (Musgrave and Musgrave 1976). Death taxes would fall under this category as would our income tax system. Taxpayers with greater wealth would pay a higher marginal tax rate under this criterion. The underlying assumption behind this principle is that people with equal wealth will suffer the same utility loss if they pay equal taxes (Musgrave and Musgrave 1976).

The benefit principle links the tax share of individuals with the marginal benefits received from government services

(Hyman 1979). Modern day examples of benefit financing are tolls, user charges and fees. However, it is hard to determine an appropriate rate structure because it will depend on income and price elasticity of demand for the benefit provided. The rate structure will be proportional, progressive or regressive if income elasticity equals, exceeds or falls short of price elasticity respectively (Musgrave and Musgrave 1976). This means we would need to know price and income elasticities for various public goods. These are not known or easily obtained from market observation and they will differ among various types of public services (Musgrave and Musgrave 1976).

When either the benefit or ability to pay criterion is chosen, the particular approach should then be examined on economic principles. Three important concepts which fall in this category are efficiency, neutrality and the excess burden of taxation.

First, efficiency is usually taken to mean Pareto-optimality. Strictly speaking, this means that when a Pareto optimal point is reached, it is impossible to make a change which benefits some individuals without harming others (Baumol 1977). An example of a Pareto-optimal point is the intersection of the supply and demand curves in a perfectly competitive market. A shift in either curve will increase (decrease) the amount of consumer (producer) surplus, making one group better off at the expense of the other. A more

specific definition would be that there must be efficient resource allocation, product mix and consumption (Randall 1981). A summary condition is that the marginal rate of commodity substitution (MRCS) between two goods should equal the marginal rate of product transformation (MRPT), and both should equal the ratio of commodity prices[2] (Randall 1981).

The excess burden of taxation is directly related to efficiency. Excess burden is the amount by which the total tax burden exceeds the revenue collected. The total tax burden is revenue collected plus the cost of lost efficiency (Musgrave and Musgrave 1976). Generally, taxes add an efficiency cost because of their effect on price. If taxes affect prices, the prices no longer accurately reflect resource scarcity (Hyman 1979).

Tax neutrality means that there is zero excess burden (Hyman 1979). In other words, there is no efficiency lost by transferring private resources to the public. From a utility standpoint, there will be income, but no substitution effects (Hyman 1979). An income effect moves a consumer to a lower (higher) level of utility given constant prices and only income changes. A substitution effect is consuming more (less) of good X to the expense (benefit) of good Y in order

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[2] MRCS is defined as the amount of good X a consumer is willing to give up to gain an additional unit of good Y. MRPT is defined as the amount of output of good X a producer is willing to give up in order to produce another unit of good Y.

to maintain the same level of utility given a price change of good X (Henderson and Quandt 1980).

Achieving zero excess burden may be difficult, if not impossible, to attain because of the complex interactions of various markets. This may therefore mean a mix of taxes which minimizes the excess burden should be adopted (Musgrave and Musgrave 1984). Designing such a system would certainly be a complex task and the discussion of its impacts is beyond the scope of this thesis.

Although economic criteria are certainly important in the development of any tax system, social and political influences also play a role (Musgrave and Musgrave 1976). This means defining what constitutes a "good" tax system is often difficult. However, Musgrave and Musgrave (1976) have outlined six principles for a good tax system.

1. "The distribution of the tax burden should be equitable."

   This means that society will have to determine what is and isn't equitable. Equity, in terms of death taxes, means that in our society higher valued estates or inheritances are taxed at a higher marginal rate.

2. "Taxes should be chosen so as to minimize interference with economic decisions in otherwise efficient markets."

   This is the concept of tax neutrality. Death taxes violate this principle if they force sales of assets for

below market price. They also are non-neutral if they cause capital to move from one state or region to another.

3. "At the same time, taxes may be used to correct inefficiencies in the private sector provided they are a suitable instrument for doing so."

   The purpose behind levying death taxes generally fits into this category. That is, wealth redistribution is the primary reason for our death tax system.

4. "The tax structure should facilitate the use of fiscal policy for stabilization and growth objectives."

5. "The tax system should permit efficient and nonarbitrary administration and it should be understandable to the taxpayer."

   The current death tax code is complex and may not be understandable to the average taxpayer. Many accountants, lawyers and financial planners specialize in estate planning, which seems to indicate that the current code is not easily understood. Moreover, the tax code changes almost yearly which makes it difficult for an average person to have current information on death taxes.

6. "Administration and compliance costs should be as low as is compatible with other objectives."

   When examining this principle, the performance of death taxes depends not only on estate value, but on the type of asset transferred. The cost of transferring forested

property is generally higher than other property because in order to obtain the transfer value, the property must be appraised. The value of a bond, on the other hand, can be easily found by looking in a current issue of the Wall Street Journal. Additionally, transaction costs for selling forestland in order to fund any tax liability are generally higher then other financial assets.

These objectives are not necessarily in agreement and tradeoffs may be needed where they conflict (Musgrave and Musgrave 1976).

DEATH TAXES

Death taxes at the federal level account for a very small percentage of the total federal revenue collected. In 1979 the federal estate tax accounted for less than two percent of total federal revenue (Hyman 1979). By 1982, it accounted for only $5.2 billion or 0.8 percent of the total revenue collected (Wall Street Journal 1984, Economic Report of the President 1985).

The estate and gift tax are "in rem" taxes as opposed to personal taxes. In rem taxes mean "taxes on things" and are imposed "independently of the characteristics of the transaction or owner" (Musgrave and Musgrave 1976). The

purposes for levying death taxes as stated by Musgrave and Musgrave (1976) are:

> 1. "Society may wish to limit a person's right to dispose of his or her property at death."
>
> 2. "Society may wish to limit a person's right to acquire wealth by way of bequest's (i.e. without his or her own efforts)."
>
> 3. "Society may have the more general objective of achieving a more equal distribution of wealth."
>
> 4. "The objective may not be one of imposing a separate tax on transfers at death, but simply to correct the income tax and fully implement the accretion view of income by including the receipt of bequests as part of the taxpayer's income under the income tax."

Generally speaking, the purpose of the estate tax is to achieve societal goals of wealth distribution. However, whether the tax is accomplishing this objective is questionable. Verbit (1978) cited evidence that the wealthiest five percent of the population held 31.6 percent of this country's real estate, 29.1 percent of the cash and 66 percent of the corporate stock. He adds that "transfer taxes have had no discernible impact on personal wealth distribution or concentration since 1949" (Verbit 1978). However, he also noted that the index used to obtain his figures was not without flaw and that there was a possibility that the old rich were being replaced by the new rich (Verbit 1978).

In a model presented by Stiglitz (1978), under certain assumptions, the estate tax may increase the total inequality

of income. The three assumptions under which this proposition holds are that the estate tax leads to a reduction in savings, that the government does not take countervailing actions to offset the reduction in savings and that capital income is more unequally distributed than that of labor. If these assumptions hold, the reduction in savings will lead to a lower capital-labor ratio in the long run. If the elasticity of substitution between capital and labor is less than one, the lower capital-labor ratio will lead to an increase in the share of capital. If income from capital is distributed more unequally than labor income, "the increase in the proportion of income accruing to capital may increase the total inequality of income" (Stiglitz 1978).

Death taxes should also be examined on the principle of neutrality from a consumer utility standpoint. If an individual has a choice between consumption in his or her lifetime and consumption after death (in the form of bequests), a budget line will show the possible points of consumption (Stiglitz 1978). The point of tangency between the consumer utility function and the budget line is the optimum allocation between consumption today and bequests. A tax on consumption tomorrow (bequests) pivots the budget line toward the origin, resulting in a lower level of utility. This is shown in figure 2.1.

Consumption tomorrow (bequests) moves from point A to C and consumption today moves from point B to D. The equilibrium

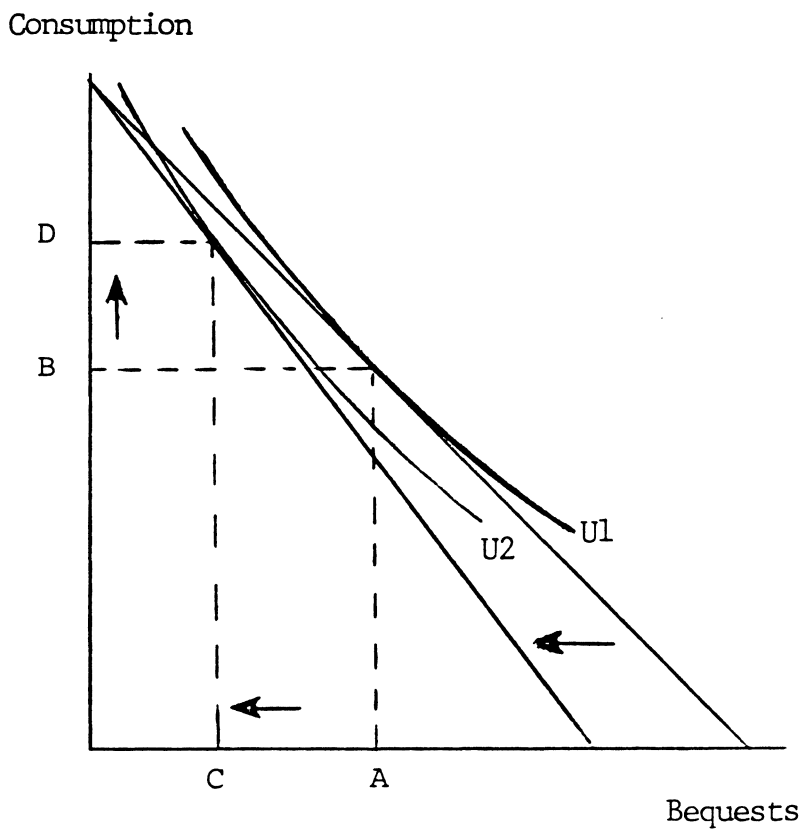

Figure 1. Effect of death taxes on a two-period consumption model.

level of utility is lowered from U1 to U2. There is both an income and a substitution effect associated with this shift. Stiglitz (1978) points out that "the income effect leads the individual to consume less during his lifetime, the substitution effect to consume more". If Stiglitz's conclusions are correct, then death taxes are non-neutral.

The estate tax should also be examined on equity grounds, under Musgrave and Musgrave's first principle of a "good" tax system. The federal estate tax is levied on the right to transfer property at death. However, the burden of death taxes must be carried by individuals. Therefore, the equity of death taxes should be examined in light of the burden which is distributed among persons (Musgrave and Musgrave 1976). This means that federal estate taxes, along with other in-rem taxes, "are inferior to well designed personal taxes imposed directly so as to allow for the taxpayer's ability to pay". (Musgrave and Musgrave 1976). If inheritances were taxed under our income tax system, societal goals may be better served and the tax would tend to be more equitable. Verbit (1978) feels that this would increase revenues and lower transaction costs. Treating inheritances in this manner would also result in no substitution effects, only income effects.

DEATH TAXES AND FORESTRY

Death taxes impact both the land and timber components of forestry investments. Both are capital assets, yet each may respond differently to the death tax levy. The supply of land is considered fixed, consequently the overall land supply will not be affected adversely. However, death taxes could cause fragmentation of land holdings and inneficiencies in production. The impact of federal and state death taxes on regional timber supplies is at this point unknown. Future projections estimate that demand for all wood products is expected to double by the year 2030 (USDA 1982). It is also estimated that demand for wood from domestic forests is expected to increase 107 percent (USDA 1982). Therefore, much of the nation's future wood supply must come from nonindustrial private forest landowners. However, it is questionable as to whether this will occur. Private forest landowners have a variety of objectives for owning woodland. In the northeast, half of the woodland owners said they owned land for esthetic enjoyment, residential purposes or as part of their farm (Birch 1982). In the south, building of a family estate was the number one reason for holding forested land (Kaiser 1982). Undoubtedly, rising stumpage prices will have a positive response on timber supply, but the magnitude of the response is unclear given the variety of landowner objectives. It is also unclear as to whether favorable tax

treatment (both estate and income) will increase future timber supplies, although it may solve equity disputes. There are also non-market goods such as watershed protection and wildlife habitat, the supply of which can be encouraged through favorable tax program for private landowners.

Death taxes may also force landowners to liquidate timber at below market price. Sutherland and Tedder (1979) warned that funding estate tax settlements through liquidation had the greatest impact on an estate's net present value (NPV) after-tax. However, Howard (1982) showed that funding by liquidation had the least impact on an estate's NPV after-tax under certain circumstances, although he assumed no price decrease in his model. NIPF landowners are competitive in nature, in that no one landowner can affect price. However, they may not face a perfectly competitive buyers market. In order to pay the estate taxes, the landowners may be forced to sell timber to a buyer who can exert market power and pay a price below fair market value. Under previous guidelines, this would make the death tax inefficient and non-neutral.

There are many issues involved with death taxes and private forest landowners. One question which needs to be addressed is "does society benefit from a heavy death tax levy on forested estates?" The benefits, as measured by revenue collected, has been decreasing over the years. Additionally, the tax does not seem to be meeting it's objective

of wealth re-distribution (Verbit 1978). The cost of the tax on forested estates could be losses in market efficiency and decreased levels of non-market goods. On the other hand, landholdings which must be sold in order to pay estate taxes may be bought by larger landholders and form more efficient management units (Howard 1982).

An alternative to death taxes may be to treat inheritances as income and tax them under the income tax system. This may create additional problems for landowners in terms of liquidity, but would probably better meet societal goals of wealth distribution. Under this system it may be possible to defer the tax on land and timber until income is actually received from a sale. This would help avoid the problem of double taxation if the land and timber were subject to both an income and property tax in the same year without producing income. The specifics of such a tax system would need to be investigated further before implementation.

CHAPTER 3. THE FEDERAL TRANSFER TAX SYSTEM

HISTORY

The first transfer tax levied in this country was by the War Revenue Act of July 1st, 1862. This act imposed a legacy tax on the transfer of personal property and a stamp tax on probates of wills and letters of administration (West 1908). Under this act, a surviving husband or wife was exempt from tax and only estates of greater than $1,000 in value were subject to tax. The Act of June 6, 1872 repealed the tax (West 1908).

The War Revenue Bill of 1898 contained a provision for taxing probates of wills and letters of administration. This was voted down and replaced by a tax on legacies and distributive shares. This was subsequently repealed by the Act of April 12, 1902 (West 1908).

Our present estate tax was first enacted in 1916 to help defray the cost of preparing for World War 1. The act levied a tax between one and ten percent on estates above $60,000 in value (Bittker 1984). In the subsequent years, exemptions fluctuated between $40,000 and $140,000, and the top rate rose as high as 77 percent (Bittker 1984). The exemption was replaced by a unified credit system under the 1981 Economic

Recovery Tax Act (ERTA), and the rates were lowered to a maximum of 50 percent[3] (Bittker 1984).

The counterpart to the federal estate tax is the gift tax which was enacted in 1924. This was repealed the following year but reinstated in 1932 (Bittker 1984). Previous to this act, estate tax could be avoided by simply giving away property before death.

A third federal transfer tax was enacted in 1976 on Generation Skipping Trusts. Prior to 1976, trusts could be established which gave an income interest to an adult child, and upon the child's death, the remainder goes to the grandchildren without incurring any estate or gift tax liability. Under the 1976 act, the termination of the child's income interest is subject to a tax (Bittker 1984).

CONSTITUTIONALITY

The constitutionality of the federal estate tax has been attacked primarily on two issues. The first was that it interfered with the authority of the state to regulate the decent and distribution of property, and the second was that it was a direct tax, which the direct tax clause of the con-

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[3] The implementation of the 50% rate was delayed until 1988 under the 1984 Tax Reform Act (Commerce Clearing House 1984).

stitution required to be "apportioned among the states in proportion to their population" (Bittker 1984).

The state authority issue was examined by the Supreme Court in 1900 in Knowlton v. Moore (Bittker 1984). In its ruling, the court's opinion was that "under our constitutional system both the national and state governments moving in their respective orbits, have a common authority to tax many and diverse objects, but this does not cause the exercise of its lawful attributes by one to be a curtailment of the powers of the others; for if it did, there would practically be an end to the dual system of government which the constitution established" (Bittker 1984).

The second argument against the estate tax, that it violated the direct tax clause of the constitution, was turned down by the Supreme Court in New York Trust Co. vs. Eisner in 1929 (Bittker 1984). The court also rejected a similar argument against the gift tax in Bromley v. McCaughn in 1929 (Bittker 1984).

STRUCTURE

The current structure of the federal transfer tax was created by the passage of the 1976 Tax Reform Act. This act created a single rate and credit schedule for both the gift[4]

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[4] Internal Revenue Code (IRC) Section 2501(a).

and estate tax.[5] Rates imposed are progressive (i.e., rates rise with increasing value) and cumulative (i.e., based on the total value of wealth transferred over an individual's lifetime and at death). Previous taxable transfers must be included in estate or gift tax calculations in order to "push" the transfer up to its proper tax rate. Credit is then given for taxes paid on previous transfers.

ERTA modified two key elements of the estate and gift tax laws, the unified credit and the marital deduction. The unified credit allows a dollar-for-dollar reduction in estate or gift tax liability. ERTA increased the allowable credit to $192,800 by 1987. The phase-in schedule is shown in Table 3.1. This allows each person up to $600,000 in lifetime transfers without incurring any tax liability. Since the transfer tax is levied on the right to transfer property, it is the donor or decedent's estate which must use the credit.

ERTA modified the marital deduction by making it unlimited. Spouses are now considered one economic unit and any property passing between them is exempt from tax. The value of the transfer must still be reported to the Internal Revenue Service (IRS), but it is then deducted when determining the net transfer value. ERTA also liberalized provisions for the election of special use valuation and deferral and extension of tax payment for forested and agri-

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[5] IRC Section 2501(a).

Table 3.1. Unified Credit Phase-In Schedule

Year	Maximum Amount of Credit	Amount of Exemption Equivalent
1977	$ 30,000	$ 120,667
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981	47,000	175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and thereafter	192,800	600,000

cultural land (Gardner, Olson, Haney and Siegel 1984). Gift tax provisions were also modified. Only gifts above $10,000 per donee ($20,000 for spouses) per year are now considered taxable.

Since ERTA, there have been no major changes in the federal estate and gift tax provisions. The 1984 Tax Reform Act made some minor changes in estate and gift tax provisions by postponing the reduction in the minimum tax rate from 55 to 50 percent until 1988. The current provisions for both the federal estate and gift tax are shown in Appendix A.

FEDERAL TAX LIABILITY AT THE FIRST DEATH

In order to highlight the beneficial aspects of recent federal law, three hypothetical forest estates were established to show the federal tax burden on different size ownerships. It was assumed that the estate was located in the North[6] and was valued in the following manner: land prices were $367 per acre (USDA Economic Research Service 1984), inflation was four percent per year (Economic Report of the President 1985), and timber growth was three percent per year (Clawson 1979, pg. 388).

Characteristics of the different valued estates are described as follows:

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[6] For the states included in this region, see table 4.1.

1. Small estate - a gross value of $600,000; comprised of a fair market timber value of $118,000, land value of $112,500 and personal property of $369,500. A tree farm of this size would have roughly 272 acres. Approximately 7 percent of the owners in the North hold between 100 an 500 acres. These owners control roughly 27 percent of the land (Binkley 1983).
2. Medium estate - a gross value of $1,200,000. Comprised of fair market timber value of $360,000, land value of $338,000 and personal property of $502,000. This size tree farm would have roughly 817 acres. In the North 0.5% of the owners hold more than 500 acres and control 32% of the land (Binkley 1983).
3. Large estate - a gross value of $3,000,000. Fair market timber value equals $1,200,000, land value of $1,125,000 and personal property of $670,000. A tree farm with these values would have approximately 2,700 acres.

The decedent was assumed to have drafted a will, leaving all the property to the surviving spouse in the small estate case. In the medium and large estate cases, $600,000 in property was left to two adult children and the balance to the surviving spouse. The analysis takes place in 1987 in order to fully incorporate the tax credit provisions of ERTA. In determining the net taxable estate, certain deductions are allowable at the federal level and generally also at the

state level. For the purposes of this analysis, the following deductions will be used:

1. Deductions for funeral expenses are $5,000.
2. Administrative costs are $15,000 for the small estate, six percent of the gross value of the medium estate and three percent of the gross value of the large estate (Burkhart and Geyer 1982, Olson and Haney 1980).
3. No debts or liens exist against the property.

The federal tax liability was zero for the small, medium and large estate as Table 3.2 shows. In both the medium and large estate case, the estate value was reduced to $600,000. The tentative tax on $600,000 is $192,800, which is equal to the available unified credit. This means there is no federal tax due, which therefore eliminates any credit for state death taxes on the federal return. It should be noted that this model assumed a planned estate. An unplanned estate case is addressed in chapter 6, along with the tax levy at the second death.

Table 3.2. Federal Estate Tax Liability at the First Death for a Hypothetical Tree Farm.

	Small Estate	Medium Estate	Large Estate
	($)	($)	($)
1) Gross Estate Less	600,000	1,200,000	3,000,000
a) Funeral and Administrative Expenses	-20,000	-77,000	-95,000
b) Marital Deduction	-580,000	-523,000	-2,305,000
2) Net Estate	0	600,000	192,800
3) Tentative Federal Tax Less			
a) Unified Credit Available	-192,800[a]	-192,800	-192,800
b) Credit for State Death Taxes	0	0	0
4) Federal Tax Due	0	0	0

[a] Credit is available but not used due to the unlimited marital deduction.

CHAPTER 4. STATE DEATH TAXES

Although tax liability at the federal level may be readily eliminated, at the first death by proper estate planning, state death taxes must still be considered. There are three types of death taxes levied by individual states, which are shown in Table 4.1. They are inheritance, estate and piggy-back taxes.

An inheritance tax is a levy on the right to receive property by individual heirs or legatees. The share value received by each beneficiary forms the basis for this tax. Currently 20 states levy an inheritance tax. This is 33 percent less than the 30 states which levied inheritance taxes in 1980 (Olson 1981).

An estate tax is a levy on the right to transfer property by the decedent's estate. Currently, seven states, along with the federal government, levy an estate tax. In 1980, nine states levied an estate tax (Olson 1981).

A piggy-back tax is equal to the credit for state death taxes allowed on the federal return. The piggy-back tax is now the most widely used form of state death taxes. Twenty-two states levy a piggy-back tax, a 92 percent increase from 1980, when only twelve states utilized this form of tax (Olson 1980).

Table 4.1. Current State Death Tax Systems in the United States.

State	Estate	Inheritance	Piggy-back	Pick-up	Gift
<u>Northeast Region</u>					
Connecticut		X		X	
Delaware		X		X	X
Maine			X		
Maryland		X		X	
Massachusetts	X			X	
New Hampshire		X		X	
New Jersey		X		X	
New York	X			X	X
Ohio	X			X	
Pennsylvania		X		X	
Rhode Island	X			X	X
Vermont			X		
West Virginia			X		
<u>Southern Region</u>					
Alabama			X		
Arkansas			X		
Florida			X		
Georgia			X		
Kentucky		X		X	
Louisiana		X		X	X
Mississippi	X				
North Carolina		X		X	X
South Carolina	X			X	X
Tennessee		X		X	X
Texas			X		
Virginia			X		
<u>Midwest Region</u>					
Illinois			X		
Indiana		X		X	
Iowa		X		X	
Kansas		X		X	
Michigan		X		X	
Minnesota	X			X	
Missouri			X		
Nebraska		X		X	
North Dakota					
Oklahoma		X		X	
South Dakota		X			
Wisconsin		X			X

Table 4.1 (cont.)

State	Estate	Inheritance	Piggy-back	Pick-up	Gift
Western States					
Alaska			X		
Arizona			X		
California			X		
Colorado			X		
Hawaii			X		
Idaho		X		X	
Montana		X			
Nevada					
New Mexico			X		
Oregon			X		
Utah			X		
Washington			X		
Wyoming			X		

Additionally, 23 inheritance and estate tax states impose a "pick-up" tax. If the state death tax levy is lower than the federal credit for state death taxes, this tax "picks up" the difference. The number of states with a "pick-up" tax is 30 percent less than the 33 states which levied this tax in 1980 (Olson 1981).

In addition to death taxes, nine states levy a gift tax. Most states have incorporated federal provisions and only tax gifts above $10,000 per donee per year. In 1980, there were 15 states which imposed a gift tax (Olson 1981), which means there has been a 40 percent reduction in the states levying this tax.

Although there are only three types of state death tax systems, the specific provisions vary in each state. The allowable deductions, credits, exemptions and rates depend on state laws. Piggy-back states have tax levies which are based on the federal return and, therefore, the deductions, exemptions, rates and credits will be the same among these states. The tax statutes for estate and inheritance tax states differ, and proper tax planning must account for both the federal and state provisions.

ERTA modified key elements of the federal estate and gift taxes--the marital deduction, unified credit and effective rates. Many states have followed by changing their statutes. The current tax structure among the 50 states is

shown in Table 4.2, along with provisions for deferral and extension which will be discussed later.

Table 4.2. Current State Death Tax Structure in the U.S. 1985

State	Marital deduction exemption or credit	Rates* Min(%)	Rates* Max(%)	Special-use Valuation	Deferral and Extension
Northeastern Region					
Connecticut	$100,000 Exemption	3	14	Available	Extension allowed for filing and payment. Interest at 9% per annum
Delaware	$ 70,000 Exemption	2	16	Available cannot reduce	Extension allowed for filing and payment.
Maine	Unlimited marital	0.8	16	Indirect with federal	Extension in 1 yr. intervals not to exceed 10 years.
Maryland	None	1	10	Available	Possible, if granted by the IRS.
Massachusetts	50% or the value passed to the surviving spouse, whichever is less.	5	16	None	Extension of time for filing and payment up to 6 months. Extension of up to 3 years if undue hardship can be proved.
New Hampshire	Surviving spouse entirely exempt	15	15	None	None
New Jersey	$15,000	2	16	Available	Available if undue hardship can be shown.
New York	Unlimited marital	2	21	Available	Available
Ohio	50% or $50,000, whichever is greater	2	7	Available	Available
Pennsylvania	Jointly held property passes tax free	6	15	Available	Available if reasonable cause is shown.
Rhode Island	$175,000	2	24	None	None
Vermont	Unlimited marital	0.8	16	Indirect with federal	Deferral of payment up to 5 years.
West Virginia	Unlimited marital	0.8	16	Indirect with federal	None

* Minimum and maximum rates are for all classes of beneficiaries.

Table 4.2. (cont.)

State	Marital deduction exemption or credit	Rates Min(%)	Max(%)	Special-use Valuation	Deferral and Extension
Southern Region					
Alabama	Unlimited marital	0.8	16	Indirect with federal	Tax can be paid over a 10 year period at a variable rate.
Arkansas	Unlimited marital	0.8	16	Indirect with federal	Extension of payment up to 5 years at 10% interest.
Florida	Unlimited marital	0.8	16	Indirect with federal	Available, interest accrues at 1/2% per month.
Georgia	Unlimited marital	0.8	16	Indirect with federal	Possible, if granted by the IRS.
Kentucky	$50,000 exemption	2	10	Available	Available
Louisiana	$25,000 exemption	2	3	None	Not to exceed 15 months after death.
Mississippi	$175,625 of gross estate	1.6	1.6	Available, cannot decrease property value by more than $500,000.	Allowed in six month increments if hardship can be proved.
North Carolina	Spouse is allowed a credit of $4,650	1	12	None	Extension if reasonable reasonable cause is shown.
South Carolina	Unlimited marital	6	8	None	Extension if reasonable cause is shown. Interest at 5% per annum.
Tennessee	Unlimited marital	5.5	9.5	Available	Deferral of up to 5 year at 11% interest.
Texas	Unlimited marital	0.8	16	Indirect with federal	Deferral and extension if granted by IRS.
Virginia	Unlimited marital	0.8	16	Indirect with federal	Extension of time to file, but not time to pay.

Table 4.2. (cont.)

State	Marital deduction exemption or credit	Rates Min(%)	Max(%)	Special-use Valuation	Deferral and Extension
Midwest Region					
Illinois	Unlimited marital	0.8	16	Indirect with federal	Indirect with federal
Indiana	Surviving spouse exempt	1	10	None available	Limited availability
Iowa	Unlimited marital	0.8	16	Indirect with federal	Available
Kansas	Unlimited marital	1	5	Available	Available
Michigan	Unlimited marital	2	10	Available	Qualified farmland can defer taxes for up to 10 years.
Minnesota	Unlimited marital	10	12	Available	Available
Missouri	Unlimited marital	0.8	16	Indirect with federal	Available
Nebraska	Property passing to surviving spouse by will is exempt.	1% of property valued above $10,000		None available	None available
North Dakota	Unlimited marital	0.8	16	Indirect with federal	None available
Oklahoma	Unlimited marital	0.5	10	None available	None available
South Dakota	Surviving spouse exempt	1.5	7.5	None available	None available
Wisconsin	Surviving spouse exempt	2.5	12.5	None available	None available

Table 4.2. (cont.)

State	Marital deduction exemption or credit	Rates Min(%)	Rates Max(%)	Special-use Valuation	Deferral and Extension
Western States					
Alaska	Unlimited marital	0.8	16	Indirect with federal	Available
Arizona	Unlimited marital	0.8	16	Indirect with federal	Available
California	Unlimited marital	0.8	16	Indirect with federal	Extension of time to file
Colorado	Unlimited marital	0.8	16	Indirect with federal	Indirect with federal
Hawaii	Unlimited marital	0.8	16	Indirect with federal	Indirect with federal
Idaho	Unlimited marital	2	15	Not available for timberland available for cropland	Available
Montana	Spouse and lineal decendents exempt	4	32	Available	Available
Nevada	No tax levied				
New Mexico	Unlimited marital	0.8	16	Indirect with federal	Extension of time to file
Oregon**	Unlimited marital	0.8	16	Indirect with federal	Available
Utah	Unlimited marital	0.8	16	Indirect with federal	Available
Washington	Unlimited marital	0.8	16	Indirect with federal	Indirect with federal
Wyoming	Unlimited marital	0.8	16	Indirect with federal	Indirect with federal

** Effective January 1987.

CHAPTER 5. STATE DEATH TAX LIABILITY AT THE FIRST DEATH

Since the passage of ERTA, substantial flexibility at the federal level has been provided for many forest landowners and estates. However, state death taxes are often overlooked.

In order to highlight the differences among state death taxes at the first death, and to consider the total tax burden on estates of different values, tax liabilities will be compared between an inheritance, piggy-back and estate tax state. North Carolina (inheritance), South Carolina (estate) and Texas (piggy-back) were chosen for analysis.

ASSUMPTIONS

To simplify the analysis, it was assumed that the decedent's estate plan was to minimize federal tax liability subject to other family goals such as security for the surviving spouse and equitable transfer to the children. The analysis will examine the combined federal-state tax burden on small, medium and large estates whose values equal tax thresholds of the federal structure. In each case, values are converted into acreage to show the estate in a tree farm context. Southern land prices were $581 per acre in 1984 dollars (USDA Economic Research Service 1984). Average

stocking per acre is 2950 board feet of sawtimber and 1020 cubic feet[7] of pulpwood. Net annual growth is 4 percent per year (Clawson 1979, pp. 368, 369, 388). Loblolly pine was considered to be the dominant species on each site. Stumpage prices used were $142 per MBF and $15.60 per cord (Timber Mart-South 1984). Inflation was assumed to be 4 percent per year (Economic Report of the President 1985).

The values of the respective estates are:

1. Small - a gross value of $600,000; comprised of a fair market timber value of $117,000, land value (170 acres) of $112,500 and personal property value of $370,500. Approximately 7 percent of the private owners in the south have between 100 and 500 acres. This ownership class holds about 24 percent of the region's private forest land (Birch, Lewis and Kaiser 1982).
2. Medium - a gross value of $1,200,000; comprised of a fair market timber value of $360,000, land value (520 acres) of $338,000 and personal property value of $502,000. In the south, only 1 percent of the private woodland owners hold more than 500 acres. That 1 percent, however, owns 50 percent of the south's private forestland (Birch, Lewis and Kaiser 1982).

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[7] These figures are averages for southern PNIF land only.

3. Large - a gross value of $3,000,000; comprised of a fair market value of $1,183,000, land value (1721 acres) of $1,125,000 and personal property value of $692,000.

The analysis was done as of 1987 in order to incorporate the full tax credit provisions of ERTA.

In determining the allowable deductions, the same ones as were used in demonstrating the federal tax liability will be used in this case. In both the medium and large estates, property valued at $600,000--which is equal to the exemption equivalent--is left to the children and the remained to the surviving spouse.[8] It is further assumed that all of the property in each of the three estates is held in the husband's name, that he dies first, and that no debts or liens exist against the property.

COMBINED FEDERAL-STATE TAX LIABILITY IN A PIGGY-BACK STATE

In Texas, a piggy-back state, the state statutes closely follow the federal. The net taxable estate and tax liability for each of the three cases is shown in Table 5.1.

The combined federal-state tax implications for the three estates are the same as in chapter 3. By use of the

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[8] For discussion purposes the timberland assets may be transferred in fee, trust or by tenancy in common without losing economies of scale for management of the tract.

Table 5.1. Combined Tax Liability for a Hypothetical Forested Estate in Texas.

	Small Estate	Medium Estate	Large Estate
	($)	($)	($)
1) Gross Estate Less	600,000	1,200,000	3,000,000
a) Funeral and Administrative Expenses[a]	-20,000	-77,000	-95,000
2) Marital Deduction	-580,000	-523,000	-2,305,000
3) Net Taxable Estate	0	600,000	600,000
4) Tentative Federal Tax	0	192,800	192,800
5) Less Unified Tax Credit	-192,800[b]	-192,800	-192,800
6) Federal Tax Liability	0	0	0
7) Credit for State Death Taxes	0	0	0
8) State Tax Liability	0	0	0

[a] Section 2053(a) of the Internal Revenue Code allows deductions for funeral expenses only to the extent they are allowed under state law.

[b] Unified credit is available but unused due to the marital deduction.

marital deduction, both state and federal death tax liablity for each of the three estates has been completely avoided at the death of the first spouse. However, if the second person does not plan carefully, the tax burden may be heavier on his or her estate.

COMBINED FEDERAL-STATE TAX LIABILITY IN NORTH CAROLINA

Since North Carolina is an inheritance tax state, its laws differ greatly from those in Texas. In examining the total tax liability, it is assumed that the federal tax burden will be minimized. This is accomplished by setting the children's share exactly equal to the unified transfer credit. Each child's share in the medium and large estates thus will be 25 and 10 percent, respectively. The balance in each estate is shielded with the marital deduction;[9] therefore, the tax liability at the federal level will be zero.

Deductions for administrative and funeral expenses are limited by law. Funeral expense deductions cannot exceed the lesser of $1,250 or two percent of the gross estate. The amount deducted for a monument cannot exceed $2,500. Additionally, there is no marital deduction. Instead, the sur-

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[9] It is also assumed, for several technical reasons, that the executor is directed not to pay any taxes from the share passing to the surviving spouse (Rothenberg 1982).

viving spouse is allowed a credit of $4,650. If he or she does not use all of the credit, the remainder is divided among the surviving children.

The estate tax liability for each estate size is shown in Table 5.2. In determining the net taxable estate, it is assumed that the administrative expense deduction is the same as before. However, only $1,250 in funeral expenses will be deducted, as provided by law, with an additional $2,500 deducted for the cost of a monument.

The analysis shows that the combined death tax levy (state plus federal) on the estate of a decedent in North Carolina would be much higher than on the same estate in Texas. It is interesting to note that the tax in North Carolina, as a percent of timber value, was the lowest when the wife inherited only 50 percent of the gross estate. This is due, in part, to the state's progressive rate structure and my assumptions concerning property value.

COMBINED FEDERAL-STATE DEATH TAX LIABILITY IN SOUTH CAROLINA

South Carolina, as an estate tax state, has provisions which closely follow the federal government's. Both funeral and administrative expenses are fully deductible in South Carolina. There is also an unlimited marital deduction allowed in South Carolina, and a specific exemption of $120,000.

Table 5.2. State Tax Liability for a Hypothetical Forested Estate in North Carolina.

	Small Estate	Medium Estate	Large Estate
1) Gross Estate Less	$600,000	$1,200,000	$3,000,000
a) Funeral and Administrative Expenses	-18,750	-75,750	-93,750
2) Net Taxable Estate	581,250	1,124,250	2,906,250
3) Wife's Share of Gross Estate	100%	50%	80%
a) Tentative Tax on Wife's Share	$31,838	$30,499	$178,650
4) Credit on Wife's Share	4,650	4,650	4,650
5) Net Tax Due from Wife's Share	$27,188	$25,849	$174,000
6) Each Child's Share of Gross Estate	0%	25%	10%
a) Share Value	0	$281,063	$290,625
7) Tentative Tax on Each Child's Share	0	13,014	13,588
8) Total Tax from Children's Share	0	26,028	27,176
9) Total State Tax Liability	27,188	51,877	201,176

The tax liability for each of the three estate sizes is shown in Table 5.3. In the small estate case, the net estate was reduced to zero through the use of the marital deduction. In both the medium and large estate, $600,000 was left to the children and the rest of the estate was shielded from tax by use of the marital deduction. The net estate was further reduced to $480,000 by the specific exemption which resulted in a tax of $37,000.

It should be noted that the strategy which minimized federal tax liability did not minimize the combined tax liability. Minimizing both the federal and state tax liability would have meant leaving $120,000 to the two surviving children, which is equal to the state exemption equivalent, and shielding the remaining property with the marital deduction. However, this would underutilize the available unified credit at the federal level. This could result in a higher combined tax liability at the second death than is necessary. More importantly, minimizing the combined tax levy may not yield the property distribution which was desired.

There is no tax for the small estate in both South Carolina and Texas. In the medium and large estate, it is greater than in Texas, but less than in North Carolina. This is consistent with previous results (Olson and Haney 1980). Table 5.4 summarizes the differences in tax liability among the three states.

Table 5.3. State Death Tax Liability in South Carolina.

		Small Estate	Medium Estate	Large Estate
		($)	($)	($)
1)	Gross Estate Less	600,000	1,200,000	3,000,000
	a) Funeral and Administrative Expenses	-20,000	-77,000	-95,000
2)	Marital Deduction	-580,000	-523,000	-2,305,000
3)	Specific Exemption	-120,000	-120,000	-120,000
4)	Net Estate	0	480,000	480,000
5)	Tentative Tax	0	37,000	37,000
6)	Less Additional Credits	0	0	0
7)	Total Tax Due	0	37,000	37,000

Table 5.4. Comparison of the Combined Federal and State Death Tax Liability Among Inheritance, Estate and Piggy-back States.

	Gross Estate	Net Estate	Combined Tax Liability	Tax as percent of Timber Value
	($)	($)	($)	(%)
	600,000			
Texas		580,000	0	0
North Carolina		581,250	27,188	23
South Carolina		580,000	0	0
	1,200,000			
Texas		600,000	0	0
North Carolina		1,124,250	51,877	14
South Carolina		480,000	37,000	10
	3,000,000			
Texas		600,000	0	0
North Carolina		2,906,250	201,176	17
South Carolina		480,000	37,000	3

CHAPTER 6. COMBINED FEDERAL-STATE DEATH TAX LIABILITY THROUGH TWO DEATHS

Although the federal, and in some cases the state tax burden may be eliminated at the first death, by proper estate planning, the overall planning strategy should include both spouses. Liquidity problems may arise if the surviving spouse fails to dispose of his or her assets before death or provide funding for possible death taxes. The beneficial treatment afforded surviving spouses by ERTA was meant to defer, not eliminate, the transfer tax payment. Therefore, provisions for taxes at the death of the second spouse also become important in the planning process.

The goals in any estate plan will vary depending on the individuals involved. Usually, the decedent wishes to provide for surviving family members. Secondary goals such as maximizing the net present value (NPV) of future cash flows or minimizing estate taxes can also be important.

Planning when an estate is largely composed of land and timber is especially important, not only to meet family goals, but also to avoid disrupting management plans. The right to transfer standing timber is taxable whether the land is being managed for timber production or just being held for recreational purposes.

The key variable in this estate planning process is the determination of property ownership before death. In order to point out the differences in federal and state tax burdens, caused by different ownership strategies, I will examine the present value (PV) of the combined federal-state tax levy at the death of the first spouse. This analysis will also include the tax levy at the second spouse's death. It assumes that minimization of the PV of death taxes is compatible with other family goals. The decedent's financial objective is to leave as much assets to the next generation as possible, subject to the surviving spouse maintaining the same lifestyle. This is an intermediate consumption pattern. One extreme is for the spouses to consume all assets in their lifetime. The other extreme is for the spouses to lower their standard of living in order to pass as much property as possible to the next generation. Also note, that minimization of the PV of death taxes is not the same as maximization of the PV of future cash flows. As Howard (1982) correctly points out, minimization of tax liability does not consider non-tax costs such as insurance, premiums and interest charges.

ASSUMPTIONS

Three situations will be analyzed using the medium estate from Chapter 3. First, I will examine the case when

property is held jointly by husband and wife with rights of survivorship. In the second case, property is held by the husband. A formula will leaves $600,000 of property value in a trust, income to his wife for life and the remainder upon her death to two surviving children. The rest of the property will be left to his wife. The third situation will examine the tax burden when all the property is held in the name of the husband who dies without a will (intestate).

In each case, it is assumed that the husband dies first, leaving a wife and two adult children and the wife survives her husband an additional 10 years. This simplifies the analysis because there will be no credit for previously taxed property available after ten years at the state level (because of the unlimited marital deduction, this is not relevant at the federal level).[10] The tax levy at the death of the second spouse will be discounted using a 10 percent interest rate. I will assume the tax is paid nine months after each spouse dies. Therefore, the tax liability at the first spouse's death will be discounted nine months and the second spouse's death tax liability will be discounted 10 3/4 years. I will also assume that the surviving spouse consumes the asset growth before her death. This means that at her death, she will have the amount she inherited in her estate. In the

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[10] It is also assumed, as before, that the executor is directed not to use any property passing to the surviving spouse for payment of the tax.

analysis, I examine the present value of the combined federal-state death tax levy in a piggy-back (Vermont), estate (New York) and inheritance tax state (Pennsylvania).

STATE LAWS DETERMINE TAX LEVY

In my three examples, the tax levy is largely determined by state law. This is especially true for the unplanned estate because each state has its own laws of descent and distribution.

VERMONT

Vermont, as a piggy-back state follows the federal IRS rules for determining what is included in the gross estate, along with the allowable deductions, exemptions and credits. In the joint ownership case, under IRC section 2040, only one-half of jointly owned property with rights of survivorship is included in the gross estate if property is held by spouses. This affects the gross estate valuation of the first spouse to die.

In the trust example, the property placed in trust could qualify for the marital deduction as a Qualified Terminable Interest Property (Q-TIP) under IRC section 2056(b)(7). To make the Q-Tip election, (1) the property must pass from the

decedent to the surviving spouse, (2) the surviving spouse must be entitled to all of the income from the property, payable annually or at more frequent intervals for life, (3) there must be no power of appointment vested in anyone, including the surviving spouse, to appoint any part of the property to anyone other than the surviving spouse, and (4) the election must be made by the decedent's executor (Bittker 1984). The Q-Tip property which has not been consumed by the surviving spouse at his or her death would be taxable at that time.

In this example, I assume that the executor does not elect to use the Q-Tip provisions and takes advantage of the marital deduction. This strategy is utilized for two reasons; (1) by electing to include trust assets in the marital deduction, the executor loses an important tax saving tool, which is the ability to transfer $600,000 tax free; and (2) the trust proceeds would be taxable at the surviving spouse's death, which is similar to the joint ownership case. Therefore, I will treat the trust as a terminable interest which does not qualify for the marital deduction under IRC section 2056(b) (Bittker 1984).

If the decedent dies without a will, the estate is distributed according to Vermont laws. In this example, with a surviving spouse and two children, the spouse is entitled to a maximum of one-third of the estate and the children get the

remaining two-thirds. I will assume that the spouse is awarded the maximum share allowed.

NEW YORK

New York, as an estate tax state, has laws which are similar to those of the federal government. In the joint ownership case, only one-half of the gross estate value is taxable if the property is owned by spouses.

In the trust example, the laws of New York are identical to those of the federal government. The executor may elect to treat the trust proceeds as Q-Tip property and take advantage of the marital deduction. The guidelines which must be met in order to qualify are the same as those at the federal level. As in Vermont, I assume that the Q-Tip is not elected, and therefore, the trust will not qualify for the marital deduction.

When a person dies intestate, the laws of New York govern property distribution. In my example, the spouse would receive $4,000 and one-half of the gross estate, and the balance would go to the two children.

PENNSYLVANIA

Pennsylvania, as an inheritance tax state, has laws which are quite different from those of New York and Vermont.

In the joint ownership case, all property is exempt from tax if the joint owners are husband and wife. Therefore, there will be no federal or state tax at the first death.

For the trust example, the analysis is slightly more complex. The value of the wife's interest income share and the children's remainder must be determined using annuity tables. Fortunately, Pennsylvania uses the same annuity tables as the IRS does for determining gift tax liability. In my example, the analysis is simplified because the surviving spouse and children are taxed at the same rate. Therefore, the $600,000 in trust is all taxed at a six percent rate.

In the unplanned estate case, under Pennsylvania statutes, the surviving spouse is entitled to the first $30,000 plus one-half of the balance of the intestate estate. The remainer will go to the surviving children.

RESULTS AND DISCUSSION

The tax liability at each death, under the different planning assumptions, is shown in Table 6.1. The total present value of death tax liabilities is also shown in Table 6.1.

Table 6.1. Federal and State Tax Liability after Two Deaths.

State	1st Death Federal	1st Death State	2nd Death Federal	2nd Death State	PV
	($)	($)	($)	($)	($)
Vermont					
Strategy					
Joint	0	0	137,719	36,035	59,567
Trust	0	0	0	0	0
Unplanned	34,670	20,336	0	0	51,047
New York					
Strategy					
Joint	0	0	137,719	57,550	66,942
Trust	0	25,500	0	24,300	31,995
Unplanned	0	22,980	0	22,200	28,937
Pennsylvania					
Strategy					
Joint	0	0	137,719	63,037	68,823
Trust	0	67,380	0	34,800	74,461
Unplanned	0	67,380	0	34,290	74,286

FORMULA-WILL TRUST EXAMPLE

In Vermont, utilizing a formula-will trust resulted in no tax at either the first or second death. This was because both spouses fully utilized their available unified credit. In New York and Pennsylvania, the trust yielded only a slightly higher total tax than the unplanned case. In Pennsylvania, it was higher than the joint ownership case because there was a moderate tax at the first death, whereas the joint ownership case deferred all the tax until the second death. When examining this situation, it should be remembered that any savings in taxes should be weighed against the administration costs of the trust.

JOINT OWNERSHIP STRATEGY

In Vermont and New York, the greatest PV of death taxes was found under the joint ownership strategy. In Pennsylvania, death taxes were minimized using this plan, even though the PV of taxes was higher than in the other two states. This strategy resulted in no federal or state tax at the first death in all three states, which meant it was all deferred until the second death. In Pennsylvania, this yielded the lowest PV of death taxes among all three strategies.

UNPLANNED

The tax burden in the unplanned case depended on state laws. In Vermont, there was a moderate state and federal tax levy at the first death, but none at the second. The law distributed the estate in such a manner that the wife had a net estate of less than $600,000 at her death. This is the most that can pass tax-free by utilizing the available unified credit under ERTA. Laws of distribution sometimes have the same effect as a formula planning strategy. Unfortunately, this is often not the case, and there may be an unnecessary amount of state tax.

In New York, the lowest PV of death taxes was found under the unplanned case. This was due to the specific laws of descent and distribution, and the estate size which was examined. The unplanned case in Pennsylvania was intermediate in effect, which was once again due to it's laws and the estate size examined. Although this example yielded the lowest tax in one case, there are disadvantages to dying with an unplanned estate. In other states, the tax burden may be much higher than in my examples. Additionally, the surviving spouse loses control over much of the estate which is something that may be undesireable.

Remember, that these results are specific to the states used in the analysis. Other states have laws which may change these results, particularly in the unplanned estate case. The analysis does show, however, the different results

which may be obtained depending on where the decedent resided. It also shows in two states, the problems associated with joint ownership of assets. Although joint ownership gives equal control to both spouses, estate planning options may be lost.

CHAPTER 7. SPECIAL FORESTRY PROVISIONS

Under the 1976 Tax Reform Act, provisions were enacted which allowed farms or other closely held businesses to be valued at current-use rather than at highest and best use. The House Ways and Means Committee felt that it was "desireable to encourage the continued use of property for farming and other small business purposes" (Bittker 1984). The Committee reasoned that those who had been involved in farming should be encouraged to continue the operation after the death of an owner. Under this provision, woodland was considered qualifying property which benefitted owners of forestland.

Another important provision for nonindustrial private forest landowners is deferral and extension of tax payment. This feature of the tax law was enacted in 1958 and modified by both the 1976 Tax Reform Act and ERTA. Under section 6166, payment of that portion of the estate tax (attributable to a closely held business) may be deferred up to 5 years (with interest) and then paid over a 10 year period in equal annual installments. Currently, qualified woodland can take advantage of this provision.

The following sections examine both special-use valuation and deferral and extension in greater detail at both

the federal and state level and focus on valuation techniques used in determining a special-use valuation.

SPECIAL-USE VALUATION

The 1981 Economic Recovery Tax Act (ERTA) modified the special-use valuation statutes which were originally enacted under the 1976 Tax Reform Act. Under the present tax code, the provisions for special-use valuation are as follows:

1. Decedent must have been a U.S. citizen.
2. Property must be located in the United States.
3. Property must pass to qualified heir. A qualified heir is lineal descendent or ascendent, spouse, lineal descendent of the decedent's spouse, or of the decedent's parents and the spouse of any lineal descendent.
4. Property must have been owned by the decedent and/or a member of the decedent's family for at least five of the last eight years immediately before the decedent's death.
5. During at least five years of such ownership the property must have been used for farming or a closely held business purpose, which includes timber growing, by the decedent or a member of the decedent's family.
6. The decedent, or a member of the decedent's family, must have had an equity interest in the forestry operation at

the time of death and for five or more of the last eight years before death.

7. The decedent and/or a family member must have materially participated in the operation of the business for at least five years during the eight year period on the earliest of: (1) the date of the decedent's death; (2) the date on which the decedent became disabled, provided disability continued until date of death; or (3) the date on which the decedent began receiving Social Security retirement benefits, provided the benefits continued until the date of death.

8. All use valuations taken together cannot reduce the FMV of the gross estate by more than $750,000.

9. The total property (both real and personal) qualifying for SUV must constitute, at FMV, at least 50 percent of the adjusted value of the decedent's gross estate (gross estate less secured debts).

10. At least 25 percent of the adjusted value of the decedent's gross estate must be qualified real property and passed from the decedent to a qualified heir.

11. An agreement for use valuation must be signed by all persons who have inherited an interest in the forestland and filed with the estate tax return. The election can be made on a late return as it is the first return filed.

12. For the agreement to remain valid, the following requirements must be met for ten years after the decedent's

death (the ten-year period may be extended to twelve years if the full two-year grace period is utilized):

- ownership must continue solely within the decedent's family unless there is an involuntary conversion or like-kind exchange;

- at least one member of the decedent's family must materially participate in management of the property during five of every eight years; a less stringent "active management" test is substituted for "material participation" for surviving spouses and certain other classes of heirs;

- the property must be used and managed for the qualifying use, and the the qualified hier must maintain an equity interest in it. (Gardner, Olson, Haney and Siegel 1984, Bittker 1984)

After special-use valuation is elected, the qualifying property must be continued to be used for its qualifying use for ten years or else a recapture tax will be imposed. A second event that will trigger recapture tax is disposition of any part of the qualified property to anyone except a member of the heir's family (Bittker 1984). Caution should, therefore, be exercised before electing special-use valuation

because this option, for a variety of reasons, may not benefit the estate or new owners. Since timber can be included as qualifying property, the recapture penalty would be imposed on any specially valued timber sold within ten years of the election. Therefore, mature timber should not be valued at special-use unless its inclusion is necessary to qualify the entire forest estate. Even then, depending on individual circumstances, it may not be desireable. Income tax implications for the estate, and for the heirs or legatees, should also be considered, because the income tax basis for the inherited property will be its valuation for estate tax purposes.

STATE STATUTES

In addition to federal statutes concerning special-use valuation, many states also have special-use valuation provisions. The piggy-back states automatically allow special-use because the valuation of property depends directly on the Federal return. There are also several estate and inheritance tax states which have some type of special-use valuation provisions, and generally have their own statutes which may or may not differ from the federal government. The 37 states which allow special-use valuation are shown in Table 7.1, along with any important provisions for each state.

Table 7.1. States with special-use valuation statutes

State	Type of Tax System	Indirect with federal (Yes or No)	Important Provisions
Northeastern Region			
Connecticut	Inheritance	No	Similar to federal statutes
Delaware	Inheritance	No	Cannot reduce value by more than $500,000
Maine	Piggy-back	Yes	N/A*
Maryland	Inheritance	No	Farmland, woodland and national registers qualify.
New Jersey	Inheritance	No	Assessment for farmland, and some forest or timberland, is at a lower rate. Tax based on lower rate unless property is sold.
New York	Estate	No	Generally conforms to federal statutes.
Ohio	Estate	No	Cannot reduce value by more than $500,000.
Pennsylvania	Inheritance	No	Tract valued at current use must contain at least 10 contiguous acres.
Vermont	Piggy-back	Yes	N/A
West Virginia	Piggy-back	Yes	N/A
Southern Region			
Alabama	Piggy-back	Yes	N/A

* Provisions in piggy-back states are totally dependent on the federal statutes.

Table 7.1 (continued)

Arkansas	Piggy-back	Yes	N/A
Florida	Piggy-back	Yes	N/A
Georgia	Piggy-back	Yes	N/A
Kentucky	Inheritance	No	Similar to federal statutes.
Mississippi	Estate	No	Cannot reduce the estate value by more than $500,000
Tennessee	Inheritance	No	Doesn't require material participation
Texas	Piggy-back	Yes	N/A
Virginia	Piggy-back	Yes	N/A
<u>Midwestern Region</u>			
Illinois	Piggy-back	Yes	N/A
Iowa	Piggy-back	Yes	N/A
Kansas	Inheritance	No	Cannot reduce estate value by more than $750,000
Michigan	Inheritance	No	50% of the market value is exempt from tax. Tax on the balance can be deferred 10 years.
Minnesota	Estate	No	Valuation accepted at the federal level is used at the state level.
Missouri	Piggy-back	Yes	N/A
North Dakota	Piggy-back	Yes	N/A
<u>Western Region</u>			
Alaska	Piggy-back	Yes	N/A

Table 7.1 (continued)

Arizona	Piggy-back	Yes	N/A
California	Piggy-back	Yes	N/A
Colorado	Piggy-back	Yes	N/A
Hawaii	Piggy-back	Yes	N/A
Montana	Inheritance	No	Follows the federal statutes.
New Mexico	Piggy-back	Yes	N/A
Oregon	Piggy-back	Yes	N/A
Utah	Piggy-back	Yes	N/A
Washington	Piggy-back	Yes	N/A
Wyoming	Piggy-back	Yes	N/A

DEFERRAL AND EXTENSION OF TAX PAYMENT

Deferral of tax payment is available for an interest in a closely held business under IRC section 6166. The act which preceded section 6166 was enacted in 1958. Congress felt that by incorporating this provision, "it will be possible for the estate tax in most cases to be paid out of earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the Federal estate tax without upsetting the operation of the business" (Bittker 1984). The committee went on to state that it believed "that this provision is particularly important in preventing corporate mergers and in maintaining the free enterprise system" (Bittker 1984). Since 1958, the 1976 Tax Reform Act and ERTA extensively modified the features of section 6166. The current provisions for election are as follows:

1. The interest in a closely held business must exceed 35 percent of the decedent's adjusted gross estate. Interest in a closely held business means an interest in enterprises which are carrying on a trade or business. This means that an interest in a holding company does not qualify.
2. The estate is required to pay interest only for an initial five-year period, the principle can be paid in two

to ten equal annual installments. The rate of interest is roughly 4 percent for the first $1,000,000 of value.

3. The deferral is terminated if there is a disposition of any portion of the qualifying interest, the estate has undistributed income or the interest and deferred installments of principle are not paid on time.
4. A protective election may be filed if the executor is unsure if the final estate values will be sufficient to meet the requirements for election (Bittker 1984).

The statutes regarding deferral and extension are quite complex. For a more complete discussion, see Bittker (1984).

Extension of payment can also be granted under IRC section 6161(a)(1), for income, estate and gift taxes. Additionally, IRC section 6161(a)(2) allows extension of tax payments not to exceed 10 years. These provisions are available to individual taxpayers and differ from section 6166. Extension is available if the IRS feels there is "reasonable cause". What determines reasonable cause is somewhat vague; however, factors such as liquidity, future payments, unascertainable estate size, and insufficient funds to pay the tax while providing for the support of the survivors are all factors which may be considered (Bittker 1984). The IRS can require a bond to insure payment under IRC section 6165, and collect interest on the deferred amount.

Whether an estate qualifies depends on the IRS. However, denials of extension can be subject to administrative review.

STATE STATUTES

Many states also allow deferral and extension of tax payment. The provisions vary and no two states have the same statutes. Table 7.2 lists the 37 states which allow deferral and extension, along with their provisions.

VALUATION OF PROPERTY

Determining a special-use value for woodlands can cause particular problems. The approach used can make a difference in property values acceptable to the IRS. A number of methods are acceptable to the IRS for determining a special-use value. The preferred method for valuing farmland used for farming purposes is the capitalization of rents paid for comparable land. The numerator used is "the average annual gross cash rental for farming land in the same locality as the farm being valued minus the average annual state and local real estate taxes for comparable land" (Bittker 1984). The denominator is the "average annual effective rate for all new federal land bank loans" (Bittker 1984). Averages used are to be calculated from the five most recent calendar years which ended before the decedent's death (Bittker 1984). Although this method is preferred for valuing farmland, it is very limited when applied to forestland. Finding rental data

Table 7.2. States allowing deferral or extension of taxes

State	Extension for filing (Yes or No)	Deferral or Extension of Payment (Yes or No)	Important Provisions
<u>Northeastern Region</u>			
Connecticut	Yes	Yes	Interest at 9% per annum
Delaware	Yes	Yes	If extension is granted at the federal level, it is automatically extended at the state level.
Maine	Yes	Yes	One year intervals not to exceed 10 years
Maryland	No	Yes	Informally allowed under certain circumstances.
New Jersey	No	Yes	Interest accrues at a rate of 10% per annum
New York	No	Yes	Conforms with section 6166 of the I.R.C.
Ohio	No	Yes	Conforms with section 6166 of I.R.C.
Pennsylvania	Yes	Yes	May require a bond to be filed.
Vermont	No	Yes	Payment can be extended for up to five years.
<u>Southern Region</u>			
Alabama	No	Yes	Tax can be paid over a 10 yr. period at a variable rate.
Arkansas	Yes	Yes	Extension of payment up to five years at 10% interest.

Table 7.2 (continued)

Florida	No	Yes	Interest accrues at 1/2% per month
Georgia	Yes	Yes	Depends on IRS.
Kentucky	No	Yes	Interest at 8% per annum.
Louisiana	Yes	Yes	Not to excced 15 months after death
Mississippi	No	Yes	Allowed in six month increments if hardship can be proved.
North Carolina	Yes	Yes	Reasonable cause must be shown.
South Carolina	Yes	Yes	Reasonable cause must be shown.
Texas	Yes	Yes	If granted by the IRS.
Virginia	Yes	No	
Midwestern Region			
Illinois	Yes	Yes	Indirect with federal
Indiana	Yes	No	
Iowa	Yes	Yes	
Kansas	No	Yes	Requirements conform to the federal level.
Michigan	No	Yes	Qualified farmland can defer taxes for up to 10 years.
Minnesota	Yes	Yes	Payment can be extended from six months to 15 years.
Missouri	Yes	Yes	Extension cannot exceed 4 years.

Table 7.2 (continued)

Western Region			
Alaska	Yes	Yes	Extension cannot extend beyond 5 years.
Arizona	Yes	Yes	
California	Yes	No	
Colorado			
Hawaii	Yes	Yes	Indirect with federal
Montana	No	Yes	Can defer payment for 5 or 15 years.
New Mexico	Yes	No	
Oregon	No	Yes	
Utah	Yes	Yes	Payment can be extended for up to 10 years
Washington	Yes	Yes	Indirect with federal
Wyoming	Yes	Yes	Indirect with federal

for forestland is difficult if not impossible (Champagne 1984).

Congress has also provided "the multiple-factor valuation method" in the event that rental data is unavailable. Any one of five criteria may be used under this method. They are:

1. the capitalization of income from the property for farming or a closely held business purpose for a reasonable period of time under prudent management;
2. capitalization of the land's fair rental value as farmland or as a closely held business;
3. state's assessment, if it differentiates between land used for farming or a closely held business and other property uses;
4. comparable sales in the same geographic area, if it is far enough from a metropolitan or resort area so nonagricultural use is not a significant factor in the sale price;
5. any other factor which puts fair value on the property for farming or other closely held business purposes (Bittker 1984).

The method used to value woodland will depend on the location and characteristics of the woodland being appraised. If property is located near a large population center or any

other external factor which puts upward pressure on rural land values, the capitalization of income from the current land use would be a good method of establishing value. Another, simpler approach would be to use current-use property tax values. Income tax considerations should also be accounted for before electing special-use valuation. The income tax basis for the heirs will be the valuation determined using special-use valuation. Property which is given a low valuation may incur substantial capital gains tax if sold after the recapture period has expired.

VALUATION TECHNIQUES

Determining a special-use value can be a challenging, and sometimes difficult task. The techniques used must satisfy the IRS and will determine the heirs' basis. Therefore, the executor should be careful in selecting the valuation method. In the following section, I will compare timberland valuations obtained by using the methods outlined under section 2032(a). All of the methods will not be appropriate for forestland; consequently, the discussion will be limited to those techniques which are applicable to forestland.

STATE CURRENT USE VALUATION

Current use valuation for property tax purposes by states provides a straightforward approach to valuing timberland. Using this technique, both land and timber would

be given one lump sum value. Gardner (1984) showed how current-use values were obtained for pine plantations in Virginia. Average yields for 35 to 45 year old pine were multiplied by the current average stumpage price. Land management expenses were then subtracted. Net annual income per acre was obtained by dividing the net income per acre by the economic rotation age. This was then divided by an appropriate capitalization rate which gave the current value per acre for forestland use. For excellent sites, using a 10% interest rate, Gardner (1984) determined the current-use value was $400 per acre. However, this value is very sensitive to interest rate changes and has some theoretical shortcomings. Usually, the executor will not have any discretion in determining a state current-use value because they will have been determined previously by state property taxing authorities.

FAIR RENTAL VALUE

The fair rental value method of valuing timberland has limited applications. It depends of the availability of timber industry lease data in the particular area where current-use valuation is desired. Gardner (1984) reported that in the south, the most common practice for valuing is the capitalization of the rental value based on industry

leases. These values are variable and may be nonexistent in some areas.

In order to show a current use value which a lease may produce, a hypothetical case was constructed using a loblolly pine example and based on a model used by Shaffer, Klemperer and Meyer (1984), which was modified somewhat. The formula used is as follows:

$$\left[\frac{H_1(1+f)^{nt}(1+g)^{nt} - c[H_1(1+f)^{nt}(1+g)^{nt} - D_1]}{(1+i)^{nt}} + \frac{H_2(1+f)^{n}(1+g)^{n} - c[H_2(1+f)^{n}(1+g)^{n} - D_2}{(1+i)^{n}} - R\frac{(1+f)^{y}}{(1+i)^{y}} - \frac{R(1-t)(1+f)^{n}}{(1+i)^{n}} - M(1-t)\frac{(1+r)^{n} - 1}{r(1+r)^{n}} \right] / m = P_i$$

where

H_1 = thinning revenue in current dollars based on yields in year nt (per acre)

H_2 = harvest income per acre in current dollars

D_1 = depletion unit used for thinning. This equals (Basis/volume) x volume cut.

D_2 = depletion unit at the final harvest. This equals Basis - D_1

R = reforestation cost per acre in real dollars occurring in years y or n

M = annual management costs per acre in real dollars occurring from years 1 through n.

n = number of years of the contract.

y = number of years delay before harvesting existing timber and reforesting the tract

c = capital gains tax rate

nt = number of years until a thinning occurs

f = anticipated annual inflation rate

i = nominal interest rate including risk for the timber investment

r = real interest rate for the timber investment

g = anticipated annual real rate of price increase above inflation

m = payment multiplication factor for present value purposes

$$m = (1-t)(1+r)\frac{(1+r)^n - 1}{r(1+r)^n}$$

Note that this will determine the maximum yearly amount which a firm is willing to pay for leasing land. This may differ from the minimum amount which a landowner is willing to accept for leasing his or her land. In this example, I will assume that the amount which a firm is willing to pay is equal to the minimum acceptable level for the landowner.

The assumptions which are used in my example are as follows:

1. length of lease is 40 years
2. existing timber is to be cut in 5 years
3. harvest revenue is 2493.06 in today's dollars ($142.00/MBF x 16.59 MBF + $15.60/cord x 8.80 cords)
4. Thinning revenue is $88.92 in today's dollars ($15.60/cord x 8.80 cords) occurring in year 25 of the contract.
5. Regeneration cost is $150 per acre occurring in years y and n.
6. Annual management costs are $7 per acre, which includes ad valorem property taxes.
7. Inflation rate of 4%.
8. No real price increases (g=0)
9. A marginal tax rate of 46% on ordinary income for the firm and a 28% capital gains tax rate. State income taxes are ignored.
10. A nominal interest rate of 7% is assumed.
11. With 4% inflation, a real interest rate of 2.9% is used.
12. Yields were obtained from the programs CoYield and PcWthin (Amateis, Burkhart, Knoebel and Sprinz 1984; Burk, Burkhart and Cao 1984). Initial density was 700 trees per acre on site index 60 land. Depletion units were calculated in cubic feet at year 25 and 35.

Stumpage prices were estimated from Timber-Mart South and costs were based on work by Gayer (1984).

Using the above set of assumptions, a lease payment of $27.69 was calculated. Capitalizing this by a 10% rate yields a current-use value of $276.90.

CAPITALIZATION OF INCOME

Under the multiple factor method, the "capitalization of income expected from using the property for farming or closely held business purposes over a reasonable period of time under prudent management" (Bittker 1984) is an appropriate determination of special-use valuation. In essence, this method determines a "bid-price" for the land if it were being sold as a farm or woodland. This determines one value for both land and timber on any given parcel.

The provision which does not allow qualifying property to be disposed of within 10 years restricts the sale of standing timber if this approach is used. Therefore, if the timber is mature, it may be wise to use another method to obtain a land value, and not include the timber as qualifying property.

In order to show an example of valuation using the income approach, a hypothetical forest property was established. It is comprised of three stands of young growth loblolly pine, which are 10, 12 and 14 years old. The site

index for all three stands is 60. It is assumed that the heirs want to continue forest management on the tract and regulate their holdings so they may obtain yearly income. A timber harvest scheduling model utilizing area control regulation is used to solve this problem. Regulation in three periods is desired; however, this cannot occur until after the 10-year recapture period has expired. The functional form for this model is as follows:

$$\text{Max} \sum_{i=1}^{3} \sum_{j=1}^{10} V_{ij} AX_{ij} + \sum_{i=1}^{3} \sum_{j=1}^{10} V_{ij} TH_{ij}$$

subject to

$$\sum_{i=1}^{3} \sum_{j=1}^{10} AX_{ij} + \sum_{i=1}^{3} \sum_{j=1}^{10} TH_{ij} = A_i$$

$$\sum_{i=1}^{3} \sum_{j=1}^{10} AX_{ij} + \sum_{i=1}^{3} \sum_{j=1}^{10} TH_{ij} = A_t/10$$

where,

AX_{ij} = the area cut in stand i in period j

TH_{ij} = the area cut in stand i in period j and subjected to a thinning at age 25

V_{ij} = the net present value of an acre

A_i = the area in stand i

A_t = the total forested area.

The analysis is done before tax with annual taxes and reforestation costs subtracted from the Net Present Value figure. A before-tax 10 percent interest rate is used in the model. The regulations state the "effective interest rate" used by the Federal Land Bank for new loans in the district where the property is located is to be used as the capitalization rate. This is determined by an average rate on new loans for the past 5 years (Everett 1984). The analysis uses 1984 as the base year in order to compare the results with Gardner (1984). The maximum present value obtained from this timber harvest scheduling model using linear programming is $715,476.40.

The regulations stating what management costs can be subtracted are somewhat vague. The capitalization of rent approach to valuation only allows property taxes to be subtracted. Although not specifically stated, conversations with IRS personnel indicate that they take this position with the capitalization of income approach. Therefore, the present value of annual taxes was subtracted from the value given by the harvest scheduling model. Annual taxes of $4.00 per acre were assumed based on an average figure calculated from Gayer (1984). The nominal 10 percent interest rate was adjusted downward to account for inflation, which yielded a real rate of 5.8 percent. The present value of taxes was calculated as a 40 year terminating annual series (see Gunter and Haney 1984). Subtracting the present value of taxes over

the planning horizon leaves a value of $641,395. The cutting schedule for this harvest regime is shown in Table 7.3.

Although using this method may seem to restrict the value which can be obtained, it does seem to follow "the prudent management" statement contained in the provisions for capitalization of income valuation method. However, acceptance would be determined by the IRS on an individual case basis. When comparing this method with the values obtained from the state current-use valuation and capitalization of lease method, the capitalization of income yields the highest value. Using state current-use valuation yields a value of $480,000. Capitalization of lease income, using a 10% interest rate yields a value of $332,280.

CONCLUDING COMMENTS

Section 2032(a) has become one of the most complex provisions in the Internal Revenue Code. The requirements which must be met in order to qualify as stringent and preclude many estates from qualifying. This was not the original intent of Congress when this provision was passed. The sought-after relief which was desired for landowners has become non-existent.

If an estate qualified under section 2032(a), an appropriate valuation must be determined. Valuing forestland can be a very complex task. The regulations are vague in this

Table 7.3. Optimal Timber Harvest Schedule Used to Determine a Special-Use Value.

Period	Stand Harvested	Acres Harvested	PNW
1	2	120	49,491.6
2	3	120	66,621.6
3	3 (thinned)[1]	120	83,809.2
4	3 (thinned)	120	86,716.8
5	2 (thinned)	80	51,798.4
	3 (thinned)	40	28,958.4
6	2 (thinned)	120	76,674.0
7	1 (thinned)	120	75,235.2
8	1 (thinned)	120	70,804.8
9	1 (thinned)	120	65,901.6
10	1 (thinned)	40	19,036.0
	2 (thinned)	80	40,428.8

			715,476.4

[1] Stand is thinned at age 25 and harvested in period shown.

area, which may mean rejection of a particular valuation by the IRS. For example, the capitalization of income approach does not specify whether a before or after tax rate should be used. It also does not state which management costs can be included in the valuation or how inflation should be treated.

The simplest method of valuing timberland may be using state current-use values for property tax purposes. This procedure is straightforward and cannot be disqualified by the IRS. However, this technique is dependent on whether a particular state provides a differential assessment.

When special-use valuation is elected, there must also be a fair-market value appraisal. This is required by the recapture provisions under IRC section 2032(a)(c)(1). Recapture tax (as computed under IRC section 2032(a)(c)(2)) will be the lessor of (1) the amount of tax saved by the special-use valuation election; or (2) the excess of the amount the fair market value over the special-use value at the disposition data (or when the property is no longer being managed for its qualifying use) (Bittker 1984).

In some instances, fair market value will equal the special-use value. This will occur in areas where forestry is the "highest and best-use" for land. There would be no advantage in electing special-use valuation in this case, because of the additional time, trouble and cost. Because

special-use valuation is such a complicated issue, legal advice should be sought before making the election.

CHAPTER 8. CONCLUSIONS

Death taxes have existed for nearly 75 years in the United States. They are generally accepted taxes by which society attempts to limit the transfer of unearned wealth. At the federal level, they are not currently accomplishing the objective of wealth distribution very effectively. The federal wealth transfer tax system accounts for a very small percentage of the total revenue collected and at present, estate taxes are regarded as a "voluntary" tax because they can be avoided by effective planning. This means that they are really a tax on ignorance and perhaps should be abolished. Additionally, the estate tax fails to meet the goals of a good tax on the basis of tax neutrality. In a two-period consumption model, it can be shown that an estate tax causes both an income and substitution effect. The presence of a substitution effect means that the tax is non-neutral.

The federal estate tax is currently half of a two-part wealth transfer tax system. Gift taxes imposed on lifetime transfers form the other half. Both taxes were substantially modified under the 1981 Economic Recovery Tax Act (ERTA). The marital deduction was modified so that spouses are now treated as one economic unit and any property passing between them by gift or at death is exempt from tax. The unified credit system was also modified, by increasing the allowable

credit in stages. This will increase the planning opportunities available for both individuals and married couples. Forest landowners now have considerable flexibility for planning their estates and maintaining larger tracts without disrupting their management plans.

Although the federal tax laws now offer greater flexibility to individuals in their estate planning, state death taxes must still be considered. Federal estate taxes on the estate of the first spouse to die may be eliminated; however, the estate may still be subjected to substantial state death taxes. Since ERTA's enactment, many states have elected to change their death tax statutes. In general, states that have followed the federal model incorporated an unlimited marital deduction and increased the allowable deductions, exemptions and credits. Since 1981, several states have changed their tax structures from inheritance or estate to piggy back. They are now the most common form of state death taxes with 22 states, followed by inheritance and estate taxes with 20 and 7 respectively. It is essential that landowners work with current information on the death tax statutes in their state in order to properly accomplish their forestry objectives when intergenerational transfers are a possibility.

In any planning process, both spouses should be included. The property division between spouses, at the first spouse's death and to whom assets are left are key elements

in determining tax liability. Joint ownerships between spouses often eliminates tax liabilities at the first death by utilizing the unlimited marital deduction. However, it can cause a particularly large tax burden at the second spouse's death. Using a trust or other arrangement may result in a lower estate tax from a present value perspective if both spouses are included. Specific results for any case will depend on individual's ages, rate of asset appreciation, discount rate and the time horizon examined. The tax savings which could be realized through a trust arrangement must be weighed against the present value of the costs associated with administering the trust and the disadvantage of the survivor losing some control and flexibility over the assets. Incorporating these costs may make the trust less attractive. In some circumstances, due to the unlimited marital deduction and the UTT credits, dying with an unplanned estate may be less costly in terms of tax liability than owning property jointly. However, this is highly dependent on state laws and should not be left to chance. Costs of administration will normally be higher in an unplanned estate. Perhaps more importantly, the distribution of assets by state law rarely coincides with the decedent's plans and may completely negate the original intentions of the owner. It is, therefore, foolish to forego the opportunity to plan for disposal of assets after death. The consequences, particularly for owners of forestland, can be devastating to the survivors.

Congress intended to provide estate tax relief to farmers, forest landowners and owners of small, closely held businesses through section 2032(a) of the Internal Revenue Code. This special-use valuation provision has fallen far short of accomplishing the objectives outlined by Congress. IRS attempts to prevent any unintended use of this section has resulted in making it one of the most complicated pieces of the tax code. This has discouraged many taxpayers and their advisors from utilizing it to their full advantage. It is this type of complexity that adds to the taxpayer's and society's compliance and administration costs. A good tax system tries to minimize these costs, which is where section 2032(a) fails. This may just be another example of a government initiative, designed to help the small family farmer, which has failed.

Several points are important in the estate planning process, particularly when forested property is included. First, good recordkeeping is essential. This will help establish asset value and facilitate any property division which takes place. It will also help establish active management for section 2032(a) purposes. Second, an estate plan should be formulated which includes both spouses in the process. Disposal of property should be planned to incorporate as many of the family objectives as possible. Any plan which is formulated should fully utilize the $192,800 unified credit which will be available in 1987. Failing to take ad-

vantage of these credits will result in paying an unnecessary amount of tax. Gifting provisions are also important. Substantial amounts of property can be transferred by making tax-free gifts over a lifetime. Finally, it is important to seek legal advice in the planning process.

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APPENDEX A. OVERVIEW OF THE ESTATE AND GIFT TAX CODE

Estate Tax Provisions

Section #	Purpose
2001(a)	A tax on the transfer of the estate of every decent who is a citizen of the United States.
2001(b)	The tax shall be a tentative tax computed on the sum of the amount of the taxable estate and the amount of the adjusted taxable gifts, OVER the amount of tax on post 1976 gifts based upon the total amount of the taxable gifts other than gifts that are included in the gross estate.
2001(c)	Includes the rates.
2002	The tax shall be paid by the executor.
2010(a)	Provides for a credit of $192,800--effective 1987.
2010(c)	UTT credit reduced by 20 percent of the old gift tax lifetime exemption that was used.
2011	Provides for a credit equal to the estate, inheritance, legacy, or succession tax actually paid to any state. The credit is limited to amount per table.
2012	Applicable only to gifts transfers made prior to January 1, 1977. It provides for a credit for the gift tax paid prior to 1977, that relates to property included in the gross estate. The credit is limited to a ratio of value of gifted property/total gross estate as adjusted times (tentative tax less UTT and 2011 credit).
2013	Provides for a credit for tax on prior transfers where the transferred property is included in the gross estate. The credit is the full amount of the related tax if death occurred within two years; 80% if in third or fourth, etc. The credit is limited to the tax on the gross estate less the tax on the gross estate without including the transferred property. Other limits and adjustments apply.

2014	Credit for Foreign Death taxes on property located in foreign country but included in the gross estate.
2015	Credit for tax on remainders.
2016	Any tax claimed as a credit that is recovered or refunded must be paid to the Federal government.
2031	The value of the gross estate of the decedent shall be determined by including the value at the time of death, all property, real or personal, tangible or intangible, wherever situated.
2031(b)	Provides that in the valuation of unlisted stock, value of similar businesses that are listed may be considered.
2032	If the executor elects, the gross estate may be valued as of 1) the date of disposition if disposed within 6 months of death; 2) value of property 6 months after death if not disposed; 3) if the value of the interest is affected by the mere lapse of time, it shall be value as of date of death with no adjustment.
2032(c)	No election may be made under this section unless the election will decrease the value of the gross estate and the amount of tax under this chapter.
2032(d)	Election once made is irrevocable.
2032A	Special valuation of certain farm and business real property--if the decedent was a citizen of U.S. and executor elects, then the value of qualified real property shall be its value for the use under which it qualifies as qualified real property. The aggregate decrease in the value of qualified real property shall not exceed $750,000.
2032A(b)	The term "qualified real property" means real property located in the U.S. which was acquired from or passed from the decedent to a qualified heir of the decedent or a member of the decedent's family, but only if (A) 50% or more of the adjusted value of the gross estate consists of the adjusted value

of real or personal property which is qualified.
(B) 25% or more of the adjusted value of the gross estate consists of the adjusted value of the real property which meets the requirements of (A)(ii) and (C).
(A)(ii) requires the property was acquired from or passed from the decedent to a qualified heir of the decedent.
(C) requires that for 5 out of the last 8 years (i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use by them AND (ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business.

2032A(b) (2) Qualified use means used as a farm for farming purposes or use in a trade or business.

(3) Defines Adjusted Value.

(4) Provides exception to date of death for those disabled.

(5) Provides special rules for surviving spouses.

2032A(c) Provides for an additional estate if within 10 years the qualified heir disposes of the property or ceases to use in a qualified use.

2032A(d) Provides for election and requires agreement from heirs.

2032A(e) Several special definitions and rules.

2033 The value of the gross estate shall include the value of all property to the extent of the interest therein.

2034 Gross estate included dower or curtesy interests.

2035 (a) Not applicable to decedents dying after 1981.

(c) The amount of the gross estate includes the amount of any gift tax paid by the decedent or his spouse after 1976 and during the three year period before death.

(d) Gross estate includes the value as of the date of death of any property transferred which is included in the gross estate because of sections 2036 (retained life estate), 2037 (transfers taking effect at death), 2038 (revocable transfers), or 2042 (proceeds of life insurance).

2036	Gross estate includes value of all property which decedent transferred yet retained a life estate which all the possession or enjoyment of, or right to the income from the property or the right either alone of inconjunction with any person to designate the person who shall possess or enjoy the property or income therefrom.
2036(b)	Provides exception including exception of voting rights as retained interest.
2037	Gross estate includes value of property transferred if possession or enjoyment can only be obtained by surviving the decedent and the decedent has retained a reversionary interest in the property and the value of the reversionary interest exceeds 5 percent of the value of the property.
2038	Revocable transfers--gross estate includes property if keep a general power of appointment.
2039	Gross estate includes value of annuity receivable by any beneficiary by reason of surviving the decedent--other than as insurance under policies on the life of the decedent.
2039(f)	Removes from this section lump-sum distributions of annuity contracts.
2040	Joint interest.
2041	Gross estate includes property subject to a general power of appointment.
2042	GE includes life insurance proceeds.
2043	GE includes transfers for insufficient consideration.
2044	GE includes property in which the decedent had a qualifying for the marital deduction income

interest for life (Q-TIP property).

2046	Disclaimers allowed under Section 2518.
2051	Taxable estate defined as gross estate less deductions.
2053	Allows a deduction for funeral expenses, administrative expenses, claimes against the estate, and liabilities of the decedent.
2054	Losses shall be allowed as deductions.
2055	Charitable contributions shall be allowed.
2056	Allows for the marital deduction--all property included
2056(7)	Provides for Q-TIP.

Gift Tax Provisions

Section #	Purpose
2501	Provides for a TAX on transfer of property by gift, by an individual. Does not apply to non-citizen gifts of intangibles, property. Does not apply to transfers to political parties.
2502	RATE OF TAX--the tax shall be an amount equal to the excess of a tentative tax on the aggregate sum of taxable gifts for the calendar period, OVER a tentative tax computed on the aggregate sum of taxable gifts for each of the preceding calendar periods.
2502(b)	The term preceding calendar period means all periods since June 6, 1932.
2502(c)	The tax is to be paid by the donor.
2503(a)	The term taxable gifts means the total amount of gifts made during the calendar year, less the deductions provided.
2503(b)	Exclusion from gifts --Excludes the first $10,000 of gifts per donnee. However, an exception is provided for "gifts of future interest in property."
2503(c)	Provides an important exception to the future

interest exception of 2503(b)--no part of a gift to an individual who has NOT attained the age of 21 on the date of transfer shall be considered a gift of future interest IF 1. the property may be expended for the benefit of the donee and 2. will to the extent not so expended, A pass to the donee at the age of 21, and B if dead before, it goes to his/her estate.

2503(d) Specifically excludes transfers in payment of tuition and medical care.

2504 Makes it clear that in computing the taxable gifts of prior periods, the law that was in effect at that time will determine the existence and amount of taxable gifts.

2054(d) The term net gifts as used in old law shall be read as taxable gifts.

2505 Unified tax credit--credit shall be allowed of $192,800 (or lesser amounts according to the phase-in schedule), LESS the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods.

2505(c) The UTT credit will be reduced by 20% of the aggregate amount of the exemption applicable to gifts made between September 8, 1976, and December 31, 1976.

2505(d) The amount of the credit allowed should not exceed the amount of tax for the calendar year.

SUBCHAPTER B

2511 The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the gift is real or personal, tangible or intangible.

2512 Valuation of gift--gift should be the fair market value of the property.

2512(b) When property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift...

2513 Gift splitting--a gift made by one spouse to

a person other than his/her spouse shall be considered as made 1/2 by him and 1/2 by her, BUT only if both spouses are U.S. citizens at the time of the gift.

Gift splitting shall apply only if both spouses have signified their consent according to the regulations (on a gift tax return).

2513(a)(2)	Gift splitting must be elected for all gifts made during the calendar year.
2514	Powers of appointment
2516	Any transfer under a divorce agreement shall be considered as transferred for full and adequate consideration.
2517	Annuities under qualified plans.
2518	Disclaimers.
2519	Dispositions of certain life estates.
DEDUCTIONS	
2522	Charitable and similar gifts.
2523	Gift to spouse (marital deduction) FMV of property transferred to spouse.
1015(d)	Basis of property for federal income tax purposes.
6211-6216	Deficiencies in payment of UTT taxes.
6075(b)	Due date of return.

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