Estate and Gift Tax
Changes in the Federal Tax Reform Act of 1976

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The Tax Reform Act of 1976 contains the most sweeping revisions of the Federal Tax Code in years. The Act changes estate and gift tax laws, and becomes fully effective over a 5-year period.

Several provisions relate specifically to farmers and other small businesses, but the Act changes the law in so many ways that nearly every family will be affected.

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The Tax Reform Act of 1976 recognizes high rates of inflation in the economy, trends in investment requirements in modern business, and the inflexibility of the laws to adjust estate and gift tax burdens commensurate with these circumstances. These are also factors that have combined to complicate the transfer of family farms and small businesses from one generation to another. The changes in the estate and gift tax law will affect practically every family.

Recognition of the rapid inflation of land values is a major component of the new regulation as far as farmers are concerned. The old $60,000 estate exemption was totally out of date in relation to the inflated value of farm land. When the new law is fully phased in by January 1981, an estate with a net value of $175,625 after marital deduction will not be subject to federal estate taxes. This assumes that none of the unified tax credit has been used to offset taxes on gifts made prior to death.

Another improvement includes changes that treat surviving spouses, especially wives, more equitably. The new regulations also provide incentives to keep farms and small businesses in family ownership, and to keep farms in agricultural uses.

These and other changes in gift tax laws, and how they affect farmers and small businessmen, are summarized below. The revisions are complex, and can have significant effects. You should seek the advice of an attorney and/or consultant when making and updating estate plans.

Valuation of real estate

This is a change, subject to option, in the level at which farms are valued for estate tax purposes. Under certain conditions it eliminates the “fair market value” concept, under which land is valued at its highest economic use, such as for housing developments rather than for growing crops, and replaces it with an “actual use” value as farm land. It may be advantageous for some...
situations, but its full implications should be studied before being adopted.

The law provides a general formula and alternatives for determining the actual use value of farms. The general formula valuation is determined by dividing the average yearly gross cash rental of comparable farm land, less state and local real estate taxes, by the average annual effective interest rates for all new Federal Land Bank loans.

These averages are computed based on the 5 most recent calendar years preceding the decedent’s death. As an example, assume average yearly rent of $50 per acre, property taxes of $10 per acre, and an average annual effective FLB interest rate of 8 percent. The use value under these conditions would be: 

\[
\frac{($50-10)}{.08} = $500 \text{ per acre.}
\]

Several alternative-use value guidelines can be substituted for this formula when it is established that comparable gross rental values are not available.

Valuation on the basis of farm use, however, cannot reduce the gross estate value by more than $500,000. Moreover, other conditions of eligibility must be met to enable a personal representative to choose farm use valuation.

- Value of farm property must be at least 50 percent of the adjusted gross estate, and at least one-half of this value must be land and buildings.
- Property must pass to qualified heirs, which means a member, or members, of the decedent’s family.
- Other requirements are residency, citizenship, and the period of time (5 of the last 8 years) during which the decedent, or his (her) heir, owned and participated materially in the farm business.

If the farm-use value option is elected, and if the farm is sold to nonfamily members, or ceases to be used for farming within 10 years of the dece-
dent's death, the government recaptures full tax benefits derived from farm use valuation. If the farm ceases to qualify after 10 years, but before the end of 15 years, the recapture amount is reduced on a proratable monthly basis. Disqualification of any portion of the land leads to partial recapture of tax benefits.

The family member or members who inherit and operate the farm are liable for any tax to be recaptured. There is no recapture if the family member(s) to whom the farm passes dies and the farm is still eligible for the benefit.

The government places a special lien on all qualified property so valued until potential liability ends (15 years or death), or tax benefits are recaptured. Financing the farm business through traditional lenders is certain to be handicapped as long as the government lien is in effect.

The new tax law is not specific as to whether the use value concept applies to family farm partnerships or corporations. The Secretary of the Treasury will issue rules on this point.

Also, farm use valuation does not apply to gifts of land given while the donor is living. And the new law does not change the requirement that one receiving property by gift takes the donor's income tax basis on that property. These could be reasons in favor of holding low tax basis land until death. Testamentary transfers under the new law "step-up" the basis for inheritors of land to its calculated value as of December 31, 1976.

**Joint tenancy rule**

Under the old tax legislation, a wife in a co-ownership having survivorship rights did not get any credit for ownership of the farm when her husband died, unless she could prove she had contributed directly toward the purchase of the farm, or that she had received an interest by inheritance or gift from a third party. One-half of her husband's estate could pass to her tax free through operation of the marital deduction privilege.
But where the wife could not prove her contribution or ownership share, one-half, minus personal exemption of the decedent, of the joint tenancy property was subject to taxation twice: once when the husband died, and again when the wife died. If the wife died first, the surviving husband had to meet the same “consideration” test. The property held jointly with survivorship rights at the death of a decedent was included in the estate of the first to die. The decedent’s survivors had the burden of proving that the other joint owner acquired her (his) interest for consideration, or by bequest or gift.

The Tax Reform Act of 1976 helps to correct this situation by providing that husband-wife joint tenancies will be treated as if 50 percent belonged to each spouse.

The new rule, however, applies only to joint tenancies created after December 31, 1976. And the new joint tenancy must be reported on a gift tax return which, depending on the value and ownership involved, may incur an immediate tax obligation. The consequences of terminating a long-standing joint tenancy and creating a new one under the guidelines of the new legislation are uncertain.

In any case, farmers creating new husband-wife joint tenancies should file a gift tax return. It is important, however, to evaluate whether a form of joint tenancy with survivorship rights is really the best type of ownership for you. Tenancy in common, or separate ownerships, may be much more flexible and advantageous in meeting desired estate planning goals.

**Unified tax rate**

With the old tax laws, gifts given while the donor was living that exceeded permissible exclusions were taxed at lower rates than estates were taxed when one died. The new tax regulations eliminate the separate tax rate schedules for gift and estate taxes. They are replaced by a single, “unified” tax rate structure (Table 1).
The unified rates mean that taxable gifts given while the donor is living will be taxed at the same rates as transfers of property resulting from death. This eliminates one of the advantages of making lifetime transfers to avoid higher estate tax rates.

Table 1. Federal Unified Estate and Gift Tax Rate Schedule.

<table>
<thead>
<tr>
<th>If taxable estate* value is not over—</th>
<th>The tentative tax* is—</th>
<th>Plus</th>
<th>Of excess over—</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$0</td>
<td>18</td>
<td>$0</td>
<td>0</td>
</tr>
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</tr>
<tr>
<td>20,000</td>
<td>3,800</td>
<td>22</td>
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<td></td>
</tr>
<tr>
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<td>40,000</td>
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</tr>
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<td>18,200</td>
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<td></td>
</tr>
<tr>
<td>100,000</td>
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<td>30</td>
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<td></td>
</tr>
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</tr>
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<td></td>
</tr>
<tr>
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<td></td>
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<tr>
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<tr>
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<td>49</td>
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<td>2,550,800</td>
<td>70</td>
<td>5,000,000</td>
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</tbody>
</table>

*The taxable estate is the gross value of the estate less the total exemptions and deductions.

*The following example is a calculation of federal estate tax liabilities based on this schedule: Suppose a man dies in 1978 with an estate of $400,000 (after all debts and estate administration fees are paid). His spouse survives him; his will specifies that she is to receive the maximum marital deduction permitted by law, which is the larger of $250,000 or one-half of the estate. Thus, there is a tax liability on $150,000. Looking at the rate schedule, the tentative tax is $38,800. But if the man had not utilized any of the "unified credit" (Table 2) by making lifetime gifts in excess of annual exclusions, the full $34,000 credit may be deducted. This leaves a gross estate tax of $4,800. Any allowable credits, such as for state death taxes and for earlier federal estate taxes paid on property transferred to the present decedent from a transferor who died within the last 10 years, are deducted in determining the net tax to be paid. Of course, the amount of unified credit that can be deducted depends on the year the decedent dies, as well as what has already been utilized for lifetime gift transfers. (Under provisions of the old law, the immediate tax liability for the estate would have been $32,700.)
New tax credits

Two specific exemptions under the old law were eliminated: The $60,000 personal exemption on estates, and the $30,000 lifetime gift exemption. But the annual gift exclusion of $3,000 per donee has been retained in the new law, and is excluded from the 3-year rule. This rule specifies that the value of gift transfers occurring within 3 years of death will be included in the estate of the decedent for purposes of calculating estate taxes. Even the amount of any taxes paid on the gifts are to be included in the donor's estate, but full credit for the gift taxes paid is allowed after the gross taxes have been determined.

The two exemptions have been replaced with tax credits to be subtracted from calculated tentative taxes. The credit is $34,000 in 1978, and rises to a high of $47,000 in 1981 and thereafter (Table 2). The credits are more generous than the old exemptions combined. A $34,000 credit is equivalent to an estate and/or gift exemption of $134,000. A $47,000 credit is equivalent to an exemption of $175,625. This is the same as saying the tentative tax (gift or estate) on $175,625 is $47,000. ($38,800 + 32% × $25,625 = $38,800 + $8,200 = $47,000).

The tax credit, as stated previously, is a "unified" credit. That is, it is a credit allowed to each person to be used to offset taxes on gifts made while living, or taxes on the estate when one dies, or any combination of the two.

For example, assume a person makes a gift of $100,000 above the annual gift exclusion to a married daughter in 1978. The tentative gift (transfer) tax will be $23,800 (line 7, Table 1). Because no previous taxable gifts have been made, the donor, in 1978, has a unified credit of $34,000 (Table 2) that can be "drawn" upon to pay the tax. After the gift transfer is completed and the gift tax return has been properly filed, the donor, instead of having a unified credit of $34,000 to offset future transfer taxes, has only $10,200 ($34,000-$23,800).
Table 2. Federal Unified Estate and Gift Tax Credit
and Equivalent Exemption.

<table>
<thead>
<tr>
<th>For decedents dying in—</th>
<th>Unified credit</th>
<th>Equivalent exemption*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>$30,000</td>
<td>$120,667</td>
</tr>
<tr>
<td>1978</td>
<td>34,000</td>
<td>134,000</td>
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<tr>
<td>1979</td>
<td>38,000</td>
<td>147,333</td>
</tr>
<tr>
<td>1980</td>
<td>42,500</td>
<td>161,563</td>
</tr>
<tr>
<td>1981 and thereafter</td>
<td>47,000</td>
<td>175,625</td>
</tr>
</tbody>
</table>

*These equivalent exemptions are not totally comparable with the $60,000 exemption under the previous estate tax provisions because of the different tax rate structure which prevailed.

The donor makes no more taxable gifts before dying in 1982. Assume a tentative estate tax is then calculated to be $56,700. The decedent, by increases in the unified credit according to the law, will have a balance in the unified credit account of $23,200 ($10,200 + ($47,000 - $34,000)). Assuming no other credits (for prior transfer or for state death taxes), the estate tax to be paid will be $33,500 ($56,700 - $23,200).

If the gift had not been made in 1978, this decedent’s estate would probably be at least $100,000 larger; the tentative estate taxes would then be $23,800 larger, but the unified credit would be a full $47,000. The net estate taxes to be paid would not change from $33,500 ($56,700 + $23,800 = $80,500 - $47,000).

As demonstrated, there is no difference in treatment under the new law, in terms of total transfer taxes, whether one disposes of wealth while living or waits until death. One benefit from giving rapidly appreciating property while living is the avoidance of taxes on the estate of the donor on the appreciation of the donated property after the gift but before the donor’s death.

Marital deductions
Marital deductions for both estate and gift taxation have been changed and liberalized. The new estate marital deduction provides for a larger tax-free share to a surviving spouse when the estate of the decedent is under $500,000.

The old law allowed a flat 50 percent marital deduction for estate tax purposes. The new law
permits a marital deduction of up to $250,000 or 50 percent of the adjusted gross estate, whichever is greater. Wills executed or trusts created prior to 1977 that contain an open-end clause that provides for the spouse to receive “the maximum amount qualifying for the marital deduction” under the old law must be amended if the new, more liberal provision is to be effective prior to 1979.

The gift marital deduction is also more generous—with strings attached. Under the old law it was a straight 50 percent of gifts to the other spouse, plus any annual and lifetime gift exemptions. Now the treatment of marital gifts provides for an unlimited exemption from gift taxation of the first $100,000 of lifetime gifts, in addition to the annual exclusion of $3,000. There is no marital exemption for the next $100,000, but after that the 50 percent gift marital deduction again applies.

But this more generous tax-free gift marital deduction is now linked to the estate marital deduction. The estate marital deduction (whichever is larger of $250,000 or one-half of the estate) will be adjusted down when the gift deduction claimed exceeds what the exclusion would have been if the old law of 50 percent were still in effect. Thus, a tax-free marital gift of $80,000 will reduce the estate marital deduction by $40,000 when he (she) dies. A marital gift of $160,000, with $100,000 being claimed tax free, will reduce one’s estate marital deduction by $20,000. This is the amount by which the $100,000 claimed marital gift exemption exceeds one-half of the total gift of $160,000.

Carryover basis at death

Appreciation on property while owned by a decedent and passed to heirs at death, was not subject to income taxation to the heirs when they sold such property under the old law. Instead, they acquired a stepped-up basis equal to the fair market value at the time of death of their benefactor. Later, if heirs sold the property, the differ-
ence between the selling price and the stepped-up basis, adjusted for any capital improvements and/or depreciation taken since receiving the property, was subject to taxation.

Under the new law, the income tax basis of the decedent is to carry over to the inheritors. But the law also provides for a “fresh start,” with values as of December 31, 1976 being the starting point. So, with some exceptions, the tax basis of property inherited in 1977, or thereafter, will be its value as of the “fresh start” date or the date of the decedent’s acquisition if after 1976. Appreciation on inherited property from either date will be subject to income taxation (ordinary or capital gains) if and when sold by an inheritor.

In addition to the “fresh start” values as of December 31, 1976, the new law permits up to $10,000 of assets from a decedent’s personal or household effects to be excluded from income tax basis. Furthermore, the aggregate basis of all carryover basis property in the estate may be raised arbitrarily to $60,000 unless that exceeds its fair market value at the time it passes to its inheritors.

An appraisal of the farm as of December 31, 1976, is not necessary to determine the income tax basis for an inheritor of farm property. The basis is to be calculated at the death of the decedent according to a specified method. The method prorates, on the basis of time, the total increase in value from when the decedent acquired the property (decedent’s basis) to date of death between the period through December 31, 1976, and from that date to death.

An example will illustrate the method. Assume a decedent purchased bare land on December 31, 1968, and paid $100,000 for it (decedent’s basis). The decedent dies exactly twenty years later, on December 31, 1988, owning the same property but with a fair market value of $220,000. The total appreciation in value is $120,000 ($220,000 - $100,000). The proportion of this appreciation occurring in the eight years from December 31,
1968 to December 31, 1976 is calculated to be $48,000 (8/20 x $120,000). Therefore, the value on December 31, 1976, is determined to be $148,000 ($100,000 + $48,000), which becomes the inheritor's income tax basis. If the farm were sold by the inheritor sometime later for $225,000, the gain subject to income taxation would be $77,000 ($225,000-$148,000). Whether the gain is taxed as ordinary income or as capital gains will depend upon what the laws prescribe at that time. At present the law requires a holding period of at least 1 year to be eligible for capital gains treatment.

The full impact of this change in the law will not be clear nor felt for a number of years. The primary reason is the "fresh start" basis of inheritors being stepped-up initially to the end of 1976. But with the passing of time, this basis date becomes more distant and, with continued inflation, the appreciation in value of the inherited estate subject to income taxation, if sold, becomes ever larger. Many implications of this become apparent and significant for the future. It is too soon to determine if the taxing of gains on inherited property in addition to estate taxes will affect the amount of farm land that will be in the market for sale. Unfortunate socio-economic consequences can be expected if the amount is seriously reduced.

Generation skipping

The use of generation skipping instruments has been a favorite of tax advisors for a number of years. The old law permitted trusts and trust equivalents, such as life estates and insurance and annuity contracts, to split the beneficial enjoyment of assets between generations without re-taxation. For example, a decedent by will might place property in trust for a child for life, then to the grandchildren for life, with the property then going to the great-grandchildren outright. The property would not be taxed in the estate of the child nor grandchildren.
The Tax Reform Act of 1976 sets limits on this practice. Up to $250,000 per child of a decedent can be passed in the old way. Beyond this amount, a tax is imposed equal to what the tax would have been if property title had been transferred to each succeeding generation.

The specific definition of generation skipping is important if maximum advantage is to be derived under the new law. It is when two or more generations younger than the grantor have been endowed with beneficial interest in the property. A trust, or similar arrangement, for a grantor’s spouse for life, with the property going to children or grandchildren at the death of spouse, is not generation skipping. The reason is that a person to whom the grantor is or has been married, regardless of age, is considered to be of the same generation as the grantor. Therefore, only one generation younger than the grantor is involved. The importance of this is that, with proper arrangements, a spouse can still be granted all beneficial rights, other than ownership, to the nonmarital deduction portion of a farm or other property for as long as she (he) lives, without it being subject to re-taxation in her (his) estate when death occurs. Instead, ownership passes at spouse’s death to the inheritor(s) designated by the grantor, as though the property had been received directly from him (her).

Other changes of note

To preclude the necessity of selling the farm or other closely held business to pay federal estate taxes, a new 15-year installment option for deaths after 1976 has been put into effect for those who qualify. A special low rate of interest on the deferred tax is provided.

The 10-year installment provision of the old law is still in effect, but the new law eases the eligibility test. The “undue hardship” test has been changed to “reasonable cause.”
The new law allows special deductions from the estate tax for surviving orphans under age 21. This benefit is not limited to farm owners.

Conclusion
The new tax reform act has restructured the rules on estate and gift taxation. It is complicated and some parts of it require further interpretation and rulings. You should review and discuss your estate plan with your tax advisor and attorney to make sure that it will still accomplish your objectives in the light of these new rules.

Careful estate planning can help avoid unnecessary gift and estate taxes, reduce probate costs, save on income taxes, and improve the profitability of your business. You also must consider the “human” aspect of planning. Think through and list your objectives considering the feelings of other family members. Then consult your attorney and tax advisor to help you accomplish these objectives. Planning now can help prevent unnecessary problems in the future.
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