5-1-1961

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Recommended Citation

Available at: http://lib.dr.iastate.edu/farmscience/vol15/iss11/3
Saving Taxes by Planning

While tax savings alone should never be the only basis for a careful plan, here are some points of tax law and some of the tax-saving principles that may be helpful to you in planning for your estate and property distribution.

by John C. O'Byrne and John F. Timmons

TAX SAVING is legitimate and proper. You always have the right to arrange your affairs to obtain the benefit of all special tax provisions and to minimize taxes honestly. This applies both to income taxes and to estate or property transfer taxes.

As a property owner, you have a duty to your government to bear your proper share of taxes, but you're also responsible to your family and heirs to pay no more than is due. Thus, tax aspects become important considerations in planning your estate.

Each estate represents a problem peculiar to a particular family and the property involved. We suggest, therefore, that you obtain specific legal advice to fit the exact circumstances. We can in this article, however, point out the general lines of tax planning and tax saving that are available. (See also, "What Taxes and How Much?" in the March issue or reprint FS-905.)

Federal Estate Tax Planning:
Possible methods, or some combination or variation of them, for saving federal estate taxes include the following.

- Use of lifetime gifts to reduce the amount of property owned at death. Taxes on lifetime gifts usually are less than federal estate taxes on gifts at death.

- Use of the marital deduction to transfer property to a surviving spouse free of estate tax; about half of a person's property can be left to his spouse tax free. The property that passes to the spouse will be taxed in his or her estate at death. But, under the estate tax system, the tax on property divided into two piles is less than the tax would be on the property in one lump. Also, each is entitled to the full exemption allowed at death. (Many people have wills that don't give the advantage of the marital deduction. Also, the settlement provisions of many insurance policies now held don't qualify for the marital deduction. It would be wise to have both wills and insurance policies re-examined for this purpose without delay.)

When discussing your estate and property transfer plans with your attorney, always weigh carefully your real desires and the circumstances of your family. A plan that simply saves taxes may not necessarily accomplish all of the things that you actually want.
Use of a life estate to one generation followed by a remainder in the next can result in granting the use of the property to one generation for life without a tax at the death of the life tenant. This "skips" the tax that would have been due if the property had been transferred outright to one generation and then transferred again to the next. (This method, however, won't permit the benefit of the marital deduction, so it's necessary to find and set up a plan that's most advantageous according to the circumstances.)

Sometimes a combination of these methods will work out. Half of the estate, for example, might go to the spouse outright to obtain the full benefit of the marital deduction, with the other half going to the spouse for life and then to the children. Often, this combination is achieved through the use of two trusts.

These three methods (or a combination of them) apply very generally in planning any estate for tax savings. Additional tax-saving ideas will be applicable to particular plans or estates. Essentially, tax planning is the prospective application of detailed tax laws to a particular family plan.

Iowa Inheritance Tax Planning:
Methods of saving taxes vary under the inheritance tax. There's no marital deduction as in the federal estate tax. In some cases, inheritance tax savings go hand in hand with estate tax savings. In other cases, they differ or even conflict—making it necessary to consider the effects of both taxes on any plan. The major lines of inheritance tax saving, however, include the following.

- Use of lifetime gifts parallels the federal tax-saving principle. Iowa has no tax on lifetime gifts. A complete and outright gift made during life—without strings or reservations—removes that property from inheritance taxation.

- Use of the life estate and remainder often is a method of avoiding an additional Iowa tax. This works the same as for the federal tax but here, too, conflicts with the use of the marital deduction for federal taxes.

- Use of insurance payable to a named beneficiary rather than to the estate will save state inheritance taxes but not federal estate taxes. This is particularly important to smaller estates.

- Use of exemptions and different rates permitted to recipients of varying degrees of relationship can save state taxes. A father, for instance, might want to leave $40,000 worth of property to a son and his family. If he left half to the son and half to the son's wife, the son would have an exemption of $15,000 and be taxed at 1 percent on only $5,000. The daughter-in-law would have no exemption and be taxed at 5 percent on $20,000. But, if the bequest were made half to the son and half to his two children, only $15,000 would be taxed at 1 percent.

Examples . . .

Assume that a farm operator has a wife about 60 years of age and two sons, both over 21. He has an estate of $200,000 and expects to own about the same at death. The wife has no substantial property in her own name. He wants to leave all his property to his wife and sons, and the wife would leave whatever she had at death to the sons.

In planning this estate, the family and their lawyer would have to consider all of the possible contingencies—including the order of death of the family members and the ultimate beneficiaries such as daughters-in-law and grandchildren. For this example, however, assume that the farm owner will die first, leaving his wife and sons surviving. With these limited facts, there are several ways of achieving his purpose—but with different tax results.

Plan 1: If the owner willed the property to his wife for life and the remainder after her death to the two sons, he'd be allowed an exemption of $60,000 and owe a federal estate tax of $31,500. No marital deduction is allowed for the life estate to his wife. The Iowa inheritance tax—allowing an exemption of $40,000 to the widow and $15,000 to each son—would total $1,905. No tax would be due at the wife's death. The over-all tax cost on the transfer of the property from the father and mother to sons would be $33,405.

Plan 2: If he left all of the property to his wife outright, the marital deduction (disregarding debts, expenses, etc.) would be $100,000 and the exemption, $60,000—leaving a net estate of $40,000 on which a federal estate tax of $4,800 would be due. The state inheritance tax would be $5,962. However, when the wife died, leaving the property to the sons, her estate would be taxed. This time there'd be no marital deduction. Her federal estate tax would be $28,444, and the Iowa inheritance tax would be $3,532. Thus, the over-all tax cost would be $42,738.

Plan 3: If he combined the methods of plans 1 and 2, he might divide the estate into two parts—half passing outright to his wife to qualify for the marital deduction and half passing to the wife for life, remainder to the sons. The husband's federal estate tax would be $4,800; the Iowa inheritance tax, $3,415. At the wife's death, the federal tax would be $4,247; the state tax, $1,180. The over-all tax cost, in this case, would be $13,642.

Plan 4: If he divided the property, half to the wife outright and half to the sons outright, the wife's half would qualify for the marital deduction. The federal estate tax would still be $4,800, but the state tax would drop to $2,806. At the wife's death, with her estate left to the sons, the fed-
eral tax would be $4,520 and the state, $1,218. Here, the over-all tax cost would be $13,344.

Each of these four methods of distributing property to a wife and two sons provides for the wife for her life and ultimately places the total property in the hands of the sons. The over-all death tax costs for the different methods, however, ranged from a high of $42,738 to a low of $13,344. (Debts due and the costs and expenses of settling the estate have been disregarded in these examples, but the federal tax figures have been adjusted for credit for state taxes paid wherever allowable.)

There are many reasons for selecting one method of transferring property over another. A plan should never be selected solely for tax reasons without full consideration of specific family needs and characteristics. But the tax costs still are a matter of major concern. Even in the simple illustration just given of one small part of the planning process, decisions must be made on whether the over-all tax cost is to be about 7 percent of the total estate or more than 21 percent. Perhaps the real question is this: Are there compelling family reasons for the additional cost of $20,000 for Plan 1 or $30,000 for Plan 2 over Plan 3 or Plan 4?

**Using tax-free gifts:** Going on with the hypothetical example, it would be possible to reduce both income and inheritance and estate taxes further by means of planned gifts during life. During his lifetime, the husband and father could use the "split gift" provisions to transfer $72,000 worth of property to the sons free of tax in a single year. He'd use his $30,000 exemption, his wife's $30,000 exemption and four $3,000 exclusions since the transfer is treated as half given by the husband and half by the wife. Thereafter, $6,000 could be transferred to each son free of gift tax in each year.

Assuming now that the husband and father made a gift of $72,000, representing an undivided share of his farm, two lines of tax savings appear. The over-all family income tax may be reduced because the income from the sons' share of the property is taxed to them. Presumably, if the major asset was a farm and the sons received an interest in it by gift, father and sons would have formed a partnership to operate it. This would spread the income according to the agreement now owned by each and the amount of labor, machinery, livestock, etc. each contributed.

Consider also the tax results at death of the husband and father. He'd have an estate of $128,000 if he had given away $72,000. If he left half or more than half outright to his wife, the federal estate tax would amount to no more than $120. The tax would be zero if he had reduced his estate to $120,000 and qualified for the marital deduction. The federal tax at the wife's death would range from $116 to $10,800, depending on whether or not all property had gone to the wife or part to the wife and part to the sons. Iowa taxes at the wife's death, in leaving the property to her sons, would range from $480, if she had received half of the estate, to $2,150, if she had received all of it at her husband's death.

Thus, if the husband and father with an estate of $200,000 had given $72,000 to his sons during life and transferred by will at death half of the rest to his wife and half to his sons, the federal estate tax burden at death would be $120. When the wife left her half to the sons at her death, the estate tax then would be $116. The Iowa inheritance tax at her death would be $638; at her death, $476.

Considered planning — using the split gift, the marital deduction and the full Iowa exemptions — results in this situation in a total tax on both deaths amounted to $42,738! Actually, the $1,370 total tax could have been further reduced by additional lifetime gifts to the sons by husband and wife. In fact, a sound plan would provide for re-examination after the husband's death to see how the wife should handle the property thereafter and whether she should then make gifts.

**Effects of Income Taxes:** Estate and inheritance taxes fall only upon death. The gift tax falls only in years when gifts are made. Income taxes, however, are an annual affair. This makes it important to include in any plan an analysis of the effects of income taxes on the family unit during the lives of all parties and upon the spouse, children and heirs following death of the husband and father.

We won't get into detailed consideration of the income tax aspects in this article. But be sure to discuss these with your attorney as your plans progress. Sometimes income tax considerations fall into line with other tax saving devices, and sometimes they're in conflict.

**Plan Carefully . . .**

In this article, we've listed some of the considerations of tax law and some of the tax-saving principles to be considered in planning the distribution of farm and other property. But tax savings alone should never be the sole basis of a careful plan. Always weigh carefully the desires and characteristics of the family against possible tax savings.

It may be that a plan that saves taxes doesn't accomplish a property owner's real desires. A sound plan must harmonize all of these. We've indicated some of the principles to think about. Work out the details, however, with the aid of a competent lawyer and tax adviser. Then re-examine the plan periodically in the light of changes either in the tax laws or in family situation.