



Estate Planning Part 7:

Federal and State Estate Taxes

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Federal Estate Taxes

When a person dies, the value of his or her estate is subject to federal estate taxes. Estate taxes must be paid before the executor can transfer ownership of the property to the heirs. A professional accountant or attorney who specializes in estate planning can help you calculate your potential estate tax.

In 1976, federal estate taxes and federal gift taxes were combined. They are now referred to as the *unified estate and gift tax*.

The *federal estate tax* exempts from taxation a certain amount of the value of the estate. The federal estate tax has been set permanently at \$5 million and is indexed for inflation on a yearly basis. In 2018, tax laws changed that temporarily set the federal estate tax at \$11.2 million, indexed annually for inflation, from 2018 until 2025. The federal estate tax exclusion for 2021 is \$11.7 million. You can find federal gift tax exclusion amounts for other years on the IRS website ([irs.gov](https://www.irs.gov)). If the taxable value of the estate is greater than \$11.7 million (indexed for inflation), or \$23.4 million for married couples, estate taxes will be owed at a maximum tax rate of 40% on the amount exceeding the federal exclusion. At the time of death, if the total value of the taxable estate plus any taxable gifts received after 1976 is less than the federal tax exemption amount (indexed for inflation), then no federal estate taxes are owed. Given the complexity of gifting and estate taxes, it is advised to work with a credible estate planner, accountant, or attorney to use strategies to reduce tax liabilities.

The American Taxpayer Relief Act of 2012 made estate tax *portability* permanent. Portability allows for any unused portion of the federal exemption amount remaining after death to be passed to a spouse, increasing the surviving spouse's exemption limit. In other words, if a person passes away with a \$6 million estate, no federal estate taxes are owed because the taxable estate is below the exemption threshold. In addition, the remaining \$5.7 million — the difference between the exemption amount and the size of the estate — may be passed to the surviving spouse. Therefore, the surviving spouse will



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have their exemption (e.g., \$11.7 in 2021) plus an additional \$5.7 million (not indexed for inflation) at the time of death. Portability only applies to a surviving spouse and must be elected during the settlement of the first spouse's estate.

What Is Included in the Taxable Estate?

In general, everything that is under the control of the deceased person is considered in the taxable valuation of the estate, including:

- Real and personal property owned exclusively by the deceased person at the time of death
- The deceased person's share of property owned by tenancy in common (more than one owner, each with undivided interest)
- Half of property owned jointly with the spouse
- Property owned jointly with right of survivorship shared, such as property jointly owned with several others including the surviving spouse
- Life insurance proceeds payable to the estate as well as proceeds payable to others when the deceased person owned the policy
- Annuities paid to a beneficiary if the annuity is based on contributions made by the deceased person or the deceased person's employer
- Property transferred by the deceased person before death with the deceased person retaining control of the property
- Taxes on gifts made by the deceased person within three years before death

The benefits of the life insurance policy go tax free to the designated beneficiary. However, if you are the owner of the policy, you have control over it. This makes the value of the life insurance part of your taxable estate. Some people put the ownership of their life insurance policies under the name of another family member or a trust to avoid this. The trade-off is that the value of those life insurance policies are then included in the other person's estate if they die before you. If you die before the owner of the policy dies and a third person is the beneficiary, the owner of the policy will be deemed to have made a gift of the proceeds of the policy to that beneficiary. Transferring ownership to a trustee avoids this problem.

The value of the assets in your estate will be calculated as the fair market value of the property at the time of your death. These assets include real and personal property.

Are There Any Deductions for the Federal Estate Tax?

Certain expenses of the deceased person's estate are deducted from the value of the taxable estate. These expenses include:

- Liabilities of the deceased person (for example, a mortgage)
- Funeral and burial expenses
- Estate administration expenses (money paid to the executor and other professionals in settling the estate)
- Charitable deductions made as part of the estate settlement
- A marital deduction for property passing to the surviving spouse

When Are the Federal Estate Taxes Paid?

Generally, the federal estate tax return is due, and the entire tax paid, within nine months from the date of death. If it is impossible or impractical for the executor to file a reasonably complete return before the due date, the official in charge of the Internal Revenue Service office where the estate tax return will be filed can grant a six-month filing extension.

Extensions are also possible for payment of taxes due. "For reasonable cause," the executor or administrator may request one-year extensions. Interest is assessed on the unpaid balance at an established rate that is at or near the prime rate. In addition, if a significant portion of the estate consists of a closely held business, the executor may elect to pay over a 10-installment period the portion of the tax attributable to the business.

Substantial penalties, fines, or even imprisonment may be imposed for failure to:

- Make or file the estate tax return
- Pay estate taxes due
- Keep appropriate records
- Provide information required by law

What Should I Know about Kentucky Inheritance Taxes?

There are three classes of beneficiaries in Kentucky:

- **Class A:** Surviving spouse, parent, child, grandchild, brother, sister, half-brother, and half-sister
- **Class B:** Niece, nephew, half-niece, half-nephew, daughter-in-law, son-in-law, aunt, uncle, great-grandchild
- **Class C:** All persons not included in classes A or B. Cousins as well as nieces and nephews by marriage and great-nieces and nephews, are considered Class C beneficiaries

Kentucky is an inheritance tax state. This means that Kentucky imposes a tax on the value of property that passes to beneficiaries. Class A beneficiaries no longer pay a Kentucky inheritance tax. Kentucky inheritance taxes affect only estates or beneficial interests passing to Classes B and C beneficiaries. Class B beneficiaries have a \$1,000 exemption; the remainder of assets are taxable at a rate of 4% to 16%. Class C beneficiaries receive a \$500 exemption and 6% to 16% tax rate.

For deceased nonresidents who own property in Kentucky, a prorated share of the state death tax credit can also be taxed. Property of deceased nonresidents owned or located in Kentucky can include bank accounts, real estate, automobiles, boats, livestock, and household items.

The Estate Planning Series

This publication is part of a ten-part series on estate planning. The publications in this series are:

- Part 1: *Getting Started*
(FCS5-420)
- Part 2: *Your Records and Personal Information*
(FCS5-422)
- Part 3: *Selecting Your Team*
(FCS5-423)
- Part 4: *Financial Planners*
(FCS5-424)
- Part 5: *Wills and Probate in Kentucky*
(FCS5-425)
- Part 6: *Trusts*
(FCS5-426)
- Part 7: *Federal and State Estate Taxes*
(FCS5-427)
- Part 8: *Planning Your Digital Estate*
(FCS5-465)
- Part 9: *How to Settle an Estate*
(FCS5-436)
- Part 10: *A Glossary of Terms*
(FCS5-428)