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Ways to Minimize Transfer Taxes

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WAYS TO MINIMIZE TRANSFER TAXES

The Situation...

- Transferring property to heirs at death can trigger the federal estate tax when the value of the estate exceeds a certain amount.
- In 2017, the applicable exclusion amount that shields assets from the estate tax is $5.49 million and the top estate tax rate is 40%.
- The executor of an estate can take advantage of "portability" by electing to transfer any unused applicable exclusion amount of a deceased spouse to the surviving spouse.

The Impact...

- Without a strategy in place, the estate taxes Uncle Sam collects can be staggering. This example shows a gross estate of $9 million and assumes that the person has made no adjusted taxable gifts during life. It illustrates the impact of the $5.49 million applicable exclusion amount and a top marginal estate tax rate of 40%.
- Before determining the estate tax, certain settlement costs are deducted from the gross estate. These include final expenses, outstanding debts, probate costs and any estate taxes imposed by the state.

$9,000,000	Gross estate
– $1,000,000	Expenses, debts, costs, state estate taxes
$8,000,000	Estate subject to federal taxation

- Next, the estate tax rate schedule is applied to determine the federal estate tax due before credits.

$3,145,800	Estate tax due before credits
– $2,141,800	Applicable estate tax credit
$1,004,000	Net estate tax payable
$6,996,000	Balance left for heirs: roughly 75% of original estate

- Fortunately, strategies are available to lessen the impact and help taxpayers minimize the transfer taxes due at death.

The Lifetime Gift Strategy...

- Gifts that a taxpayer makes during life help reduce the size of the taxable estate at death.
- Every taxpayer may give, and avoid the gift tax on, a specified amount every year to as many individuals as desired. In 2017, a taxpayer may give up to $14,000 per person.
- The amount specified each year is called the gift tax annual exclusion and applies to gifts of a present interest—that is, gifts the recipients can enjoy right away.
- Married couples are allowed to "gift-split," which doubles the gift tax annual exclusion. For example, a wife can give $28,000 of her own assets to a special niece in 2017 and avoid the gift tax if her husband agrees to add his $14,000 exclusion to hers.
- The total amount an individual can give tax free during life and/or through the estate at death is called the lifetime gift tax exclusion, which is part of the unified credit. In 2017, the lifetime gift tax exclusion amount is $5.49 million.
- Using the annual gift tax exclusion on a strategic and regular basis can make a difference in the size of the estate that is subject to tax.
- For families seeking cost-effective ways to transfer wealth, there's an additional benefit—the appreciation in the value of property given during life means the donor is taxed less than if he or she had held the property until death.
- Another way to minimize transfer taxes is by making lifetime spousal gifts. There is an unlimited marital deduction for gift tax purposes, so spouses can allocate their property to best facilitate their estate plan.

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Unused Spousal Exclusion Strategy...

- Whether a gift is made during life or at death, transfers between spouses are not subject to tax. Taxes, however, are eventually due when the second spouse dies.
- There are ways to minimize the taxes due at the second death—including portability. If a spouse dies, the estate executor can choose to allocate any unused applicable exclusion to the surviving spouse.
- For example, if a wife dies in 2017 and leaves everything to her husband, no estate tax credit has been used because bequests to a spouse are entirely deductible by the estate. So, the executor can elect to grant the husband the $5.49 million of unused "estate tax applicable exclusion amount" for eventual use by his estate, for a combined total of $10.98 million.

The Trust Strategy...

- A lifetime gift strategy should be implemented systematically to achieve the goal of reducing an estate. One way to help ensure this is to provide gifts to an irrevocable life insurance trust (ILIT).
- An ILIT is a trust funded by a life insurance policy owned by the trust itself (not the individual insured). Life insurance held in a properly drafted irrevocable life insurance trust should not be included in the estate, whereas the proceeds of any insurance owned by the insured would be part of the estate and subject to any applicable estate taxes.
- The taxpayer/insured transfers up to the maximum tax-free gift amount (the gift tax annual exclusion, set at $14,000 for 2017), multiplied by the number of beneficiaries with present interests, each year to the properly drafted trust with Crummey powers. The trustee uses these amounts to pay the life insurance premiums.
- When the taxpayer dies, the proceeds are paid to the trust, and are free of both federal income and estate taxes when the trust is properly arranged.
- The trust holds and invests the proceeds for the benefit of trust beneficiaries.

- As long as the gift tax annual exclusion amount per person isn't exceeded, the taxpayer can set up any number of trusts naming specific individuals as the beneficiaries.

Other Strategies

- A **private annuity** typically involves two generations in the same family. The older person exchanges an asset (an interest in a closely held company, for example) for an annuity of equal value to be paid by the younger person. The older person has effectively removed the asset from the taxable estate because the annuity ceases upon death.
- An **installment sale** also often involves family members, with an older person typically selling an asset in exchange for a promissory note from a younger person.
- **Charitable giving** provides a way for the donor to meet philanthropic goals and purposefully reduce the size of his or her estate.

The Bottom Line...

Some ways to minimize transfer taxes are fairly simple to establish and execute, while others are complex in varying degrees. All require careful preparation and the assistance of tax advisors to achieve the desired results. The best method for individuals or couples can only be determined by a careful analysis of family needs, assets, and future financial objectives.

Summary

WHAT ARE TRANSFER TAXES?

At death, any part of an individual's estate that exceeds the applicable exclusion amount ($5.49 million in 2017) is subject to the federal estate tax.

WHAT IS THE EFFECT OF THESE TAXES?

The impact of this tax can be significant. In larger estates, millions of dollars may go to the IRS instead of to heirs. Fortunately, there are methods to minimize transfer taxes due at death.

HOW CAN LIFETIME GIFTS HELP?

One method involves a program of nontaxable lifetime gifts. This shrinks the size of the estate that remains when the gift-giver dies.

The maximum amount an individual can give tax free is $14,000 per recipient in 2017. This amount may be given to as many people as the taxpayer chooses. A spouse may also give up to the same amount to any number of people, which doubles the tax-free gift amount. This reduces the couple's estate and allows heirs to enjoy their inheritance sooner.

Each taxpayer also has a lifetime gift tax applicable exclusion of $5.49 million (the unified credit for gift and estate taxes).

WHERE DO TRUSTS FIT IN?

Another technique for reducing transfer taxes is an irrevocable life insurance trust. With this method, an individual makes gifts of cash to the trust, which pays premiums on a policy owned by the trust. The object of this strategy is to pay the premiums using the annual gift tax exclusion (up to $14,000 in 2017 per trust beneficiary). As with any lifetime gift of a present interest, this method can significantly reduce the estate. A married couple can elect to split a

gift made by only one of them, thereby doubling the gift tax annual exclusion (to $28,000 in 2017).

The taxpayer's heirs are beneficiaries of the trust. When the taxpayer dies, policy proceeds are paid to the trust, free of both federal income and estate taxation. This money is then held or distributed by the trust under the terms of the trust agreement.

ARE THERE OTHER STRATEGIES?

Charitable gifts, private annuities and installment sales are among other strategies that can be used effectively to transfer assets out of an estate during a taxpayer's lifetime, reducing the size of the estate that will be subject to transfer taxes at death.

PAY CLOSE ATTENTION

When looking at ways to minimize transfer taxes, those with sufficient assets must carefully analyze their personal situations and understand available options. The best methods can only be determined with the assistance of professional advisors, by a careful analysis of the needs that exist during life and the needs that are anticipated for those ultimately benefiting from transfers at death.