Ways to Minimize Transfer Taxes

The Situation…

- When an individual dies, transferring property to the heirs can trigger a federal estate tax if the value of the taxable estate exceeds a certain amount.
- In 2019, the applicable exclusion amount that shields assets from the estate tax is $11.4 million and the top estate tax rate is 40%.
- The executor for an estate can elect to transfer the unused estate applicable exclusion of a deceased spouse to the surviving spouse (called “portability” and described in greater detail later in this module).

The Impact…

- If there’s no strategy in place to minimize estate taxes, the amount ending up in Uncle Sam’s coffers can be staggering. The following example shows the impact on the estate of a wealthy decedent, taking into consideration a top marginal estate tax rate of 40% and an $11.4 million applicable exclusion amount. It shows a gross estate of $20 million, and further assumes that the person hasn’t made any adjusted taxable gifts during life.

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- ❖ Before determining the estate tax, certain settlement costs are deducted from the gross estate, such as final expenses, outstanding debts, probate costs and state estate taxes.

$20,000,000	Gross estate
– $2,000,000	Expenses, debts, costs, state estate taxes
$18,000,000	Estate subject to federal taxation

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

$7,145,800	Estate tax due before credits
– $4,505,800	Applicable estate tax credit (2019)
$2,640,000	Net estate tax payable
$15,360,000	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...

- ❖ A regular program of making gifts during the taxpayer's lifetime helps to reduce the size of the taxable estate remaining at death.
- ❖ Every taxpayer may give—to as many individuals as desired—a specified amount every year and avoid the gift tax. In 2019, a taxpayer may give up to $15,000 per person.
- ❖ This is known as the gift tax annual exclusion and applies to gifts of a present interest—that is, gifts that recipients can enjoy right away.
- ❖ Married couples are allowed to "gift-split" in order to double the gift tax annual exclusion. That way, a wife can give a friend $30,000 in 2019 and avoid the gift tax if her husband agrees to add his own $15,000 exclusion to hers.

- ❖ Every taxpayer has a lifetime gift tax exclusion amount that is a part of the unified gift and estate tax credit—the total amount an individual can give tax-free during life and/or through his or her estate ($11.4 million in 2019).
- ❖ Using the annual gift tax exclusion on a strategic and regular basis can make a real difference in the size of the estate subject to tax.
- ❖ Furthermore, for families seeking cost-effective ways to transfer wealth, an additional benefit is that the appreciation in the value of property given during life means the donor is taxed less than if he or she had held onto it and given it away through a will.
- ❖ Another way to minimize transfer taxes by making lifetime gifts is through a gift to a spouse. There is an unlimited marital deduction for gift tax purposes so spouses can allocate their property as they see fit (and to facilitate estate strategies).

The Unused Spousal Exclusion Strategy…

- ❖ Whether the gift is made during a lifetime or by an estate at death, the transfer between spouses is not subject to tax. In such a case, the taxes would ultimately be due on the death of the second spouse.
- ❖ However, there are ways to minimize the taxes due at the second death—including portability. If a spouse dies in 2019, the estate executor can choose to allocate the amount of the estate tax applicable exclusion that is not used by the estate to the surviving spouse. This means that if a wife dies in 2018 and leaves everything to her husband, no estate tax credit has been used (bequests to a spouse are entirely deductible by the estate). So, the executor can elect to grant the husband the $11.4 million unused estate tax applicable exclusion amount for eventual use by his estate, for a combined total of $22.8 million.

The Trust Strategy…

- The strategy of making lifetime gifts should be done systematically to achieve its goal of reducing the estate. One way to help ensure this is to provide the gifts through 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. If the insurance were owned by the insured, the life insurance proceeds would be part of the estate and possibly subject to estate taxes.
- The taxpayer/insured transfers up to the maximum tax-free gift amount (the gift tax annual exclusion, set at $15,000 for 2019), 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, free of both income and federal estate taxes if 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 such trusts naming certain individuals as the beneficiaries.

Other Strategies …

- A **private annuity** usually involves two generations in the same family. The older person exchanges an asset (usually an interest in a closely-held company) 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. The asset is sold in exchange for a promissory note from the younger person.

- **Charitable giving** provides a way for the donor to meet philanthropic goals and purposefully reduce the size of his or her estate.
- An **outright gift** to a charity made during the donor's lifetime could provide income tax savings in the form of an income tax deduction. A **charitable bequest** would similarly provide estate tax savings.
- A **life income gift** is a type of charitable gift that both creates a tax deduction for the donor and provides an annuity to one or more non-charitable beneficiaries. A **charitable gift annuity** is both part gift to the charity and part lifetime annuity to one or two persons that the donor selects. A **charitable remainder trust** pays one or more beneficiaries for a set number of years or a lifetime; whatever remains in the trust at the end of the trust term goes to the named charity.

The Bottom Line…

Some ways to minimize transfer taxes are fairly simple to establish and execute. Others can be complex in varying degrees. All require careful preparation and the assistance of tax advisors to be certain the desired results are achieved. The best method for individuals or couples can only be determined by a careful analysis of their current situation, along with future objectives for their assets and their ultimate estate disposition at death.

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