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UNDERSTANDING ESTATE TAXES

1. WHAT ARE ESTATE TAXES?

Estate taxes are different from and in addition to probate expenses, which can be avoided with a revocable living trust, and final income taxes, which must be paid on income you receive in the year you die.

Federal estate taxes are expensive (historically, 35%-55%) and they must be paid in cash, usually within nine months after you die. Because few estates have the cash, it has often been necessary to liquidate assets to pay these taxes. But, if you plan ahead, you can reduce and even eliminate estate taxes.

2. WHO HAS TO PAY ESTATE TAXES?

Your estate will have to pay federal estate taxes if its net value when you die is more than the exempt amount set by Congress, which adjusts for inflation annually. If you die during 2016, the federal exemption is $5.45 million. Every dollar over the exempt amount is taxed at 40%. Some states also have their own death or inheritance tax, so your estate could be exempt from federal tax and still have to pay a state tax.

3. HOW IS THE NET VALUE OF MY ESTATE DETERMINED?

To determine the current net value, add your assets, then subtract your debts. Include your home, business interests, bank accounts, investments, personal property, IRAs, retirement plans and death benefits from your life insurance.

4. HOW CAN I REDUCE OR ELIMINATE MY ESTATE TAXES?

In the simplest terms, there are three ways:

1. If you are married, use both estate tax exemptions.
2. Remove assets from your estate before you die.
3. Buy life insurance to replace assets given to charity and/or pay any remaining estate taxes.

5. USE BOTH EXEMPTIONS

If your spouse is a U.S. citizen, you can leave him or her an unlimited amount when you die with no estate tax. But there can be problems when the second spouse dies.

For example, let's say Bob and Sue have a combined net estate of $10 million. When Bob dies, he leaves everything to Sue, so no estate taxes are due at his death. When Sue dies, her estate of $10 million uses her $5 million exemption. This has been traditional planning for many married couples, but the problem is they waste Bob's exemption. With this approach, the tax bill on the remaining $5 million is a whopping $2 million!

Congress tried to fix this. Now, the executor of Bob's estate can transfer his unused exemption to Sue by filing a federal estate tax return at Bob's death. But if Sue remarries and outlives her new husband, she would lose Bob's unused exemption. Also, by leaving everything to Sue, Bob has no control over how his share of the assets are managed or distributed. Plus, any growth on the assets will be included in Sue's estate and taxed when she dies.

If Bob and Sue plan ahead, they can use both exemptions and solve these problems. A tax-planning provision in their living trust splits their $10 million estate into two trusts of $5 million each. When Bob dies, his trust uses his $5 million exemption. When Sue dies, her trust uses her $5 million exemption. This reduces their taxable estate to $0, so the full $10 million can go to their loved ones.

This also lets Bob keep control over how his share of the estate is managed and distributed (important if he has children from a previous marriage). The assets are valued and taxed only at his death, so no growth is included in Sue's estate. And the assets in Bob's trust can be available for anything Sue needs.

Married couples with estates of all sizes find these benefits appealing. (This planning can also be done in a will, but you would not avoid probate or enjoy the other benefits of a living trust.)

6. REMOVE ASSETS FROM YOUR ESTATE

One way to reduce estate taxes is to reduce the size of your estate before you die. So go ahead and spend some, and enjoy it. Also, you probably know whom you want to have your assets after you die, so why not make some gifts now? It can be very satisfying to see the results of your gifts, something you can't do if you wait until you die.

Appreciating assets are best to give because any future appreciation will also be out of your estate. Gifted assets keep your cost basis (what you paid for them), so recipients may pay capital gains tax when they sell. But the top capital gain gains rate (20%) is still less than the estate tax rate (40%) that would apply if you hold onto the assets until your death.

Some popular strategies are introduced below. Note that these are irrevocable, so you can't change your mind later.

7. TAX-FREE GIFTS

Federal law now lets you give up to $14,000 ($28,000 if married) to as many people as you wish each year. So if you give $14,000 to each of your two children and five grandchildren, you will reduce your estate by $98,000 a year (7 x $14,000), $196,000 if your spouse joins you. (This amount is adjusted from time to time due to inflation.) State laws may differ.

If you give more than this, the excess will be considered a taxable gift and will be applied to your $5+ million ($10+ million if married) "unified" gift and estate tax exemption. (If you use it while you are living, it's considered a gift tax exemption; if you use it after you die, it's an estate tax exemption.) Charitable gifts are still unlimited. So are gifts for tuition and medical expenses if you give directly to the institution.

8. IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

You can remove the value of your insurance from your estate by making an ILIT the owner of the policies. As long as you live three years after the transfer of an existing policy, the death benefits will not be included in your estate.

Usually the ILIT is also beneficiary of the policy, giving you the option of keeping the proceeds in the trust for years, with periodic distributions to your spouse, children and grandchildren. Proceeds kept in the trust are protected from irresponsible spending, creditors and even spouses.

9. QUALIFIED PERSONAL RESIDENCE TRUST (QPRT)

A QPRT removes your home, a substantial asset, from your estate now, yet you can continue to live there. It allows you to transfer your home to a trust (QPRT) for a period of time, usually 10-15 years. During this time, you continue to live there. When the trust term is up, the home transfers to the trust beneficiaries, usually your children. If you wish to stay there longer, you may make arrangements to pay rent. If you die before the trust term ends, your home will be included in your estate, just as it would without a QPRT.

A QPRT "leverages" your estate tax exemption. Since your children will not receive the house until the trust ends, its value as a gift is reduced. For example, if the current value of your home is $250,000 and you put it in a QPRT for 15 years, its value for tax purposes could be as little as $75,000. That leaves much more of your exemption for other assets.

10. GRANTOR RETAINED ANNUITY TRUST (GRAT) AND GRANTOR RETAINED UNITRUST (GRUT)

These are much like a QPRT. The main difference is that a GRAT or GRUT lets you transfer an income-producing asset (stock, real estate, business) to a trust for a set number of years, removing it from your estate -- and still receive the income. (If the income is a set amount, the trust is called a GRAT. If the income fluctuates, it's called a GRUT.)

When the trust ends, the asset will go to the beneficiaries of the trust. Since they will not receive it until then, the value of the gift is reduced. If you die before the trust ends, some or all of the asset may be in your estate.

11. LIMITED LIABILITY COMPANY (LLC) AND FAMILY LIMITED PARTNERSHIP (FLP)

FLPs and LLCs let you reduce estate taxes by transferring assets like a family business, farm, real estate or stocks to your children now, and still keep some control. They can also protect the assets from future lawsuits and creditors.

Here's how they work. You and your spouse can set up an LLC or FLP and transfer assets to it. In exchange, you receive ownership interests. Though you have a fiduciary obligation to other owners, you control the LLC (as manager) or FLP (as general partner). You can give ownership interests to your children, which removes value from your taxable estate. These interests cannot be sold or transferred without your approval, and because there is no market for these interests, their value is often discounted. This lets you transfer the underlying assets to your children at a reduced value, without losing control.

12. CHARITABLE REMAINDER TRUST (CRT)

A CRT lets you convert a highly appreciated asset like stock or real estate into lifetime income. It reduces your income taxes now and estate taxes when you die. You pay no capital gains tax when the asset is sold. And it lets you help one or more charities that have special meaning to you.

With a CRT, you transfer an appreciated asset into an irrevocable trust. In many cases, this has the practical effect of removing the asset from your estate, and if so, no estate taxes will be due on it when you die. You also receive an immediate charitable income tax deduction. The trustee then sells the asset at full market value, paying no capital gains tax, and re-invests the proceeds in income-producing assets.

For the rest of your life, the trust pays you an income. When you die, the remaining trust assets go to the charity(ies) you have chosen.

13. CHARITABLE LEAD TRUST (CLT)

A CLT is just about the opposite of a CRT. You transfer an asset to the trust, which reduces the size of your estate and saves estate taxes. But instead of paying the income to you, the trust pays it to a charity for a set number of years or until you die. After the trust ends, the trust assets will go to your spouse, children or other beneficiaries.

14. BUY LIFE INSURANCE

Depending on your age and health, buying life insurance can be an inexpensive way to replace an asset given to charity and/or to pay any remaining estate taxes. The three-year rule mentioned earlier does not apply to new policies. But you should not be the owner of the policy -- that would increase your taxable estate and estate taxes. To keep the death benefits out of your estate, set up an ILIT and have the trustee purchase the policy for you.

15. HOW TO REDUCE OR ELIMINATE ESTATE TAXES SUMMARY CHART

1. If Married, Use Both Exemptions

Living Trust with Tax Planning

• Uses both spouses' estate tax exemptions, doubling the amount protected from estate taxes and saving a substantial amount for your loved ones.

2. Remove Assets From Estate

Make Annual Tax-Free Gifts

• Simple, no-cost way to save estate taxes by reducing size of estate

• $14,000 ($28,000 if married) each year per recipient (amount tied to inflation)

• Unlimited gifts to charity and for medical/educational expenses paid to provider

Transfer Life Insurance Policies to Irrevocable Life Insurance Trust

- Removes death benefits of existing life insurance policies from estate
- Included in estate if you die within three years of transfer

Qualified Personal Residence Trust

- Removes home from estate at discounted value
- You can continue to live there

Grantor Retained Annuity Trust / Grantor Retained Unitrust

- Removes income-producing assets from estate at discounted value
- You can continue to receive income

Limited Liability Company / Family Limited Partnership

- Lets you start transferring assets to children now to reduce your taxable estate
- Often discounts value of business, farm, real estate or stock
- Can protect the assets from future lawsuits, creditors, spouses
- You keep control

Charitable Remainder Trust

- Converts appreciated asset into lifetime income with no capital gains tax
- Saves estate taxes (asset out of estate) and income taxes (charitable deduction)
- Charity receives trust assets after you die

Charitable Lead Trust

- Removes asset from your estate, saving estate taxes
- Income goes to charity for set time period, then trust assets go to loved ones

3. Buy Life Insurance

Through Irrevocable Life Insurance Trust

- Can be inexpensive way to pay estate taxes and/or replace charitable gifts
- Death benefits not included in your estate