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Estate Tax Basics

The Federal Estate Tax (not to be confused with the Income Tax) is a one-time tax imposed upon the estate of a decedent at death, but only when the value of the estate exceeds the government's exemption amount.

The exemption amount has increased dramatically in the last ten years, rising from about $600,000 to $3,500,000 in 2009. Under the strange dynamics of the law, in 2010 there is no Estate Tax at all. Under current law, which may or may not change, the Estate Tax will return next year, 2011, with a drastically lower limit of $1,000,000 in 2011. If that comes to pass, than anyone with more than that $1,000,000 in total assets will need to consider Estate Tax planning.

For estates that exceed the exemption amount, the tax rate is steep: starting at about 40% on the amount in excess of the exemption amount. Calculations of the applicable Estate Tax rates are somewhat complicated and are usually affected by multiple factors, some of which are based upon lifetime gifting.

Significantly, the Estate Tax is applied to the net estate only after certain deductions are subtracted. Valid deductions (funeral expenses, debts owed by the decedent, expenses of estate administration, etc.) reduce the estate's net taxable amount. Furthermore, assets transferred to a surviving spouse are not taxed due to the Marital Deduction. This amount is unlimited, but the assets in that Marital Trust will be subject to taxation later when the surviving spouse dies. Assets that are transferred to qualifying charitable organizations are also deducted before the Estate Tax is calculated, so the Estate Tax can be reduced or eliminated if enough money passes to charity.

If an individual dies owning more than the Estate Tax exemption amount (even if deductions may eliminate the Estate Tax), an Estate Tax return must be filed within 9 months, and, more importantly, if there is Estate Tax due, it must be paid within this nine month period.

Besides the Federal Estate Tax, other taxes of concern are the Gift Tax and the Generation Skipping Transfer Tax. The Gift Tax prevents a person from simply giving away his or her estate during lifetime in order to avoid taxation. The Generation Skipping Transfer Tax limits the effectiveness of placing assets in trust for multiple generations.

Minimizing or eliminating Estate Taxes is an important element of estate planning. Some effective estate planning techniques include the following:

1. Gifting

Under present law, it is possible for each individual to give gifts of up to $13,000.00 *per year*, *per recipient* without incurring Gift or Estate Tax consequences. Such recipients can include your children, your grandchildren, their spouses, or any other persons, even if they are not members of your family. If you are married, you and your spouse can *each* give up to $13,000.00 to any person (or persons) per calendar year.

The amount of any gifts exceeding these allowances must be subtracted from your lifetime ***gifting*** exemption, of $1,000,000 and reported to the IRS on a Gift Tax Return. Practically speaking, unless you make more than $1,000,000 of these type of excess gifts during your lifetime, you will not need to pay a Gift Tax to the IRS, but your Estate Tax exemption will be reduced instead.

2. Charitable Gifts and Distributions

Lifetime gifts to qualifying charitable organizations are exempt from Gift Tax. Additionally, any gifts left to a charity at death qualify for the Estate Tax deduction, so an individual may minimize or eliminate Estate Taxes very simply if they wish to leave assets to a charity at death. Of course, this reduces the amount available for any family members or other individuals.

3. A-B Trusts and Marital Planning

A married couple can set up a common and effective Revocable Trust arrangement to defer or eliminate Estate Taxes. This type of trust is commonly known as either a “Credit Shelter Trust,” “Family Trust,” “Exemption Trust,” or “B Trust.” The idea is that husband and wife hold their assets together in a Revocable Trust (or in separate Revocable Trusts) but when one of them dies, the decedent’s assets, up to the exemption amount, are placed in the irrevocable Credit Shelter Trust for the lifetime of the surviving spouse. The surviving spouse can receive the income, serve as Trustee, and even have access to the principal of the Trust. However, the nature of this trust is such that it will not be subject to the Estate Tax when the survivor dies!

The goal of this arrangement is to make sure that both spouses maximize the use of their Estate Tax exemptions, and minimize or eliminate any Estate Tax when the survivor dies.

Additionally, any assets above the decedent’s exemption can qualify for the Estate Tax marital deduction, either by going to the survivor directly or through another specific trust mechanism for the benefit of the survivor, which can at least eliminate any Estate Taxes at the first spouse’s death, no matter how large an estate there is.

4. Additional Techniques

Above and beyond these basic Estate Tax planning arrangements, there are a number of more complex Estate Tax arrangements that can be considered for minimizing and avoiding Estate Taxes, which will depend on the exact situation of that individual, and what level of complexity and loss of control they're willing to consider for tax savings.

Bogutz & Gordon is able to offer advice on the issues of Estate Tax planning for all clients, and also advise and prepare Estate Tax returns when required. Please call our firm for an appointment.