A closer look at the current estate and gifting tax rules

Estate and gift tax exemptions

After fluctuating for several years, federal estate tax and gift tax exemption levels were made permanent by the American Taxpayer Relief Act in 2013. The law also included an adjustment for inflation.

The estate and gift tax exemption is the dollar amount per individual that can be sheltered from federal estate or gift taxes. Individuals may choose to use this exemption by gifting wealth during their lifetime, leaving assets to heirs upon death, or a combination of both.

The estate tax exemption was made permanent at a level of $5 million (for individuals), indexed for inflation. For 2017, with the inflation adjustment, the uniform estate and gift tax exemption is set at $5.49 million. Taxable gifts made over a lifetime will also reduce the exemption amount left upon the death of an asset owner. For 2017, the annual limit for gifts to an individual was set at $14,000. This means an individual can gift that amount to any number of individuals without having to report a taxable gift. Gifts larger than that amount must be reported, will reduce the lifetime exemption amount, and may ultimately trigger the federal tax. The maximum estate and gift tax rate was set at 40%.

The law also made the "portability provision" permanent. With portability, a surviving spouse can utilize any unused portion of the deceased spouse's estate tax exemption — up to the maximum individual limit — to reduce his or her own taxable estate. The spouse must choose this provision upon the death of the first spouse. It is also important to note that previously claimed exemptions are not transferable if the surviving spouse remarries.

Estate and gift tax rules had changed frequently as tax legislation expired, which had presented challenges for long-range estate and legacy planning. With permanent exemption levels, it is important for investors to understand the implications of the tax thresholds and how they may incorporate them in estate and legacy planning.

Key estate tax figures for 2017

Estate and gift tax exemption = $5.49 million/individual
Maximum tax rate = 40%
Annual gifting exemption = $14,000/individual

Planning considerations

The permanency of the estate tax exemption dramatically reduces the number of estates that will have to pay federal estate taxes. For 2017, the exemption amounts are $5.49 million for individuals and $10.98 million for couples.

For estates falling under the exemption amount

While many estates will fall below the exemption level, this does not mean that only individuals and families with significant wealth need to focus on estate planning. The reality is that proper estate planning extends well beyond minimizing or preparing for federal estate taxes. Households within the exemption level should consider:

- Orderly transition of wealth to heirs or charitable concerns through wills or other means.
- Plans to address potential state estate or inheritance taxes. There are approximately 20 states that have different rules involving taxation on estates, including exemption amounts below the federal threshold of $5.49 million.

- Actions to avoid a lengthy and costly probate process. Beneficiary designations on retirement accounts and insurance contracts should be updated regularly. Establishing a revocable trust may also be useful in transferring other property (such as real estate, brokerage accounts) to heirs outside of the probate process.
- Planning for minors or other extended family members around successor guardianship or support.
- Steps to transfer decision-making responsibilities in case of unforeseen circumstances. These steps may include establishing a durable power of attorney.
- Living will or health-care proxy declarations, which can facilitate decisions around medical treatment or end-of-life wishes.
- Documenting wishes for final arrangements.

For estates that exceed the exemption amount

In addition to the above considerations, these individuals and families should consider estate-planning strategies to avoid or mitigate the impact of federal estate taxes including:

- Planning for liquidity at death to pay estate taxes. Life insurance trusts, for example, may be an effective strategy.
- Reducing the size of an estate through gifting. Here, an irrevocable trust may be useful.
- Transferring wealth associated with illiquid assets, such as shares of a closely held business, through the use of valuation discounts. This is often accomplished through a family limited partnership (FLP).
- Utilizing complex strategies such as a grantor retained annuity trust (GRAT), which can transition significant wealth to beneficiaries with minimal or no use of the lifetime gift and estate exemption amount.
- Charitable gift planning through trusts (Charitable Remainder or Charitable Lead Trusts) or family foundations.
- Establishing intergenerational wealth transfer through strategies such as dynasty trusts.

It is critical to work with a qualified estate planning professional to determine if any of these strategies are appropriate for your particular financial situation.

Gifting considerations

The Internal Revenue Service (IRS) defines a gift as the transfer of property — or any type of asset — while receiving nothing or something less than equal value in return. The IRS imposes a tax on gifts and limits the amount of assets that can be transferred between individuals without being subject to the tax. The maximum annual exclusion amount is currently $14,000 per individual donor per year, or $28,000 per couple. If the gift exceeds the annual exemption, the amount is applied to the donor's lifetime gift limit. Ultimately, the amount applied to the lifetime limit will affect the calculation of the donor's estate tax.

Certain transfers are not considered gifts:

- Direct tuition or medical payments
- Transfers between spouses
- Annual transfers that do not exceed the maximum allowed ($14,000 per individual for 2017)

Tax advantages of a 529 plan

For those wishing to make gifts toward higher education and contribute to a 529 savings plan, there are additional tax advantages. A donor may make five years' worth of gifts at one time, for a total of $70,000. As long as the transfers per recipient do not exceed the $14,000 annual exclusion amount (or $28,000 for spousal gifts), the total amount is not affected by taxes.

Choosing to gift during lifetime

Assets may be transferred during an individual's lifetime as well as upon death. The following table outlines several considerations for making gifts while living.

Case for gifting while living

✓ **Help heirs** while you are still living.

✓ **Reduce estate assets now** to avoid or minimize estate taxes in the future.

— The gift plus its future appreciation is removed from the estate of the donor.

✓ **Minimize income taxes now.** The gifting of income-producing assets can shift the tax burden to family members in lower tax brackets.

✓ **Ability to use certain valuation discounts** in transferring family-owned businesses and farms.

— For example, gifts of closely held businesses may be eligible for significant discounts in value, up to 30% in some cases, due to the fact that these ownership shares are not readily transferable in the open market. This is considered a "lack of marketability" discount. Also, these gifts may have limited rights attached, which would trigger a "lack of control" discount.

✓ **Certain states tax estates but not gifts.** Lifetime gifts may help minimize certain state-imposed estate taxes.

✓ **Asset protection.** Gifting can shift assets to family members with less creditor risk.

Case against gifting while living

X **Donors lack control** over the assets after the gift has been completed, although trusts can help donors maintain some level of control over gifted assets.

X **Loss of assets.** There is the possibility that there will be a future need for assets previously gifted to meet significant costs such as medical expenses, surviving spouse income needs, or helping settle future estate-related costs.

X **Loss of step-up in cost basis** on appreciated assets at death. With gifting, the recipient typically assumes the original cost basis while heirs receiving assets at death generally assume date-of-death cost basis on inherited assets.

X **Potential for asset value(s) to decline** after a gift has been made.

X **Potential that federal estate tax may be repealed** in the future.

— This scenario may be unlikely due to the need for additional revenue to combat rising federal budget deficits.

Permanent exemptions provide clarity for planning

To understand how the estate tax and gift tax rules may affect your personal financial plan, it is important to consult a financial advisor. Individuals considering advanced planning strategies around estates and gifting should work with a qualified estate planning attorney who has knowledge of their financial situation and goals.

This information is not meant as tax or legal advice. Please consult with the appropriate tax or legal professional regarding your particular circumstances before making any investment decisions.

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