HOW TO REDUCE YOUR ESTATE TAXES WITH GIFTS

A Private Clients Group Article

One of the goals of an estate plan is to reduce taxes and maximize your legacy for your heirs. Lifetime gifting can be an effective tactic offering significant tax savings. Gifts may not be appropriate in every situation, but it's important to understand the rules and consider the advantages they may offer as part of your estate plan.

1. You have a lifetime gift tax exemption of up to $5,490,000. During your lifetime, you can give up to $5,490,000 in total lifetime gifts without the imposition of any federal gift tax (although a state gift tax could apply if you are a Connecticut resident or make a gift of Connecticut real estate). However, the use of all or part of this exemption during your lifetime will result in a corresponding reduction in your federal estate tax exemption at death.

2. You can gift up to $14,000 each year to as many people as you want without paying a federal gift tax or using any of your lifetime gift exemptions. This amount is per person per year so married couples can give $28,000 per year to as many people they want as long as each spouse gifts $14,000. This does not include gifts that are a direct payment of tuition or medical expenses of another person which are also tax-free and don't use any gift tax exemption. So for example, you can pay your grandchild's tuition directly even if it's over $14,000 per year and still make a $14,000 gift to the grandchild, all without using any of your lifetime gift exemption.

3. Gifts that use exemptions can save in taxes even though there is less exemption remaining at death. Gifts that use gift tax exemptions will reduce the amount that can be sheltered from estate taxes at death. However, using exemptions during your lifetime can significantly reduce estate taxes due at your death if the gift tax exemption is properly leveraged. By making a gift of an income producing or appreciating asset, you can effectively give away the future income or future appreciation without any exemption or that part of the gift, whereas if you retained the asset until your death, its value and the value of your estate would be greater.

4. Sometimes it pays to make a gift even if it results in tax being due. Making a taxable gift that exceeds your exemption and results in a gift tax being due can still be advantageous for very large estates since all future income earned by the gifted property, as well as all increases in value, will escape transfer taxation at death. Moreover, the gift tax paid itself is like a deduction for estate tax purposes because it reduces the estate during your lifetime. However, there are pitfalls to this approach so it's important to evaluate the pros and cons with an experienced estate planning attorney before making any gifts that may result in taxes being due.

5. Choose the property you want to gift wisely. There are personal and tax reasons for selecting certain property to gift. For example, insurance policies can be particularly good gifts. Typically, the donor doesn't need the cash value of the insurance policy to live on during his/her life so there isn't a concern about giving it away. At the same time, it can provide a significant tax savings to the estate and beneficiary because the death benefits from the income will not be taxable in the estate. When choosing property to gift, it's important to take into account factors such as whether it is expected to appreciate at a high rate of return, whether it has a low tax cost basis,

and when is the best time to make the gift from a valuation standpoint.

6. Trusts can offer additional benefits. Trusts can help you reduce estate taxes and control the management of the trust funds for beneficiaries. The most common trusts, include the following:

a. Life Insurance Trust. A Trust can be created to hold your life insurance policy, which is ideally suited for gift-giving because a transfer of such policies often has no gift tax consequence and makes no impact on your current financial situation. For an added benefit, you can set up the trust so that you use your annual gift tax exclusion to pay the annual premiums on the policy.

b. Simple Estate Reduction Trust. These trusts are typically used instead of an outright gift when there is a concern about protecting the beneficiary. For example, if the beneficiary is a minor, disabled, or may be unduly influenced, a trust can offer extra protection. It can also help shield the gift from potential creditors of the beneficiary.

c. Qualified Personal Residence Trust (QPRT). With a properly structured QPRT, you may place a family residence (either primary or vacation) in a trust that expires after a stated period of years at a discounted value. At that point, ownership passes to the remainder beneficiaries, children, or a trust for their benefit.

d. Grantor Retained Annuity Trust (GRAT). A GRAT is particularly useful when an asset is expected to increase substantially in value over a relatively short period of time. The grantor makes a gift to the trust but the trustee pays an annuity of a specified dollar amount to the grantor for a certain number of years. The advantage is that the transfer tax value of the gift effectively can be eliminated by calculating the amount of the annuity and the term of the trust so that, according to the IRS' actuarial tables, there should be little left for the beneficiaries of the GRAT when the trust ends. In reality, if the actual performance of the trust assets exceeds the IRS assumptions used to value this gift, there may be substantial property left in the trust when it ends and that property will pass tax-free to the intended beneficiaries.

e. Charitable Remainder Unitrust. Once funded by the grantor, these trusts pay back to the grantor, each year, a stipulated percentage of the trust assets. At the end of the trust, whatever trust property remains goes to charity. The advantage is an immediate income tax deduction for the future value of the gift to charity, as well as the ability for the donor to generate additional tax-free income and thereby potentially increase cash flow.

f. Generation Skipping Trust. Each person can leave a lifetime total up to $5,490,000 (as indexed for inflation in 2017) in trust for succeeding generations without triggering a generation-skipping transfer tax. This exemption can be increased, or "leveraged," by allocating it to lifetime gifts of appreciating property. However, these trusts are sophisticated devices and require careful planning and discussion prior to implementation.

Gifting can be an effective estate planning tool, but must be evaluated in light of your personal circumstances. Contact a Cummings & Lockwood trusts and estates attorney to determine whether these strategies are right for you.

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