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Federal Gift and Estate Tax

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What is federal gift and estate tax?

Federal gift and estate tax is sometimes referred to simply as estate taxes or transfer taxes, although your estate may be subject to other kinds of transfer taxes (i.e., state death tax and generation-skipping transfer taxes).

When you die, you will leave behind all your possessions, property, and debts. What you leave behind is called your estate. Not surprisingly, estate tax is imposed on your estate, but it is also imposed on gifts you make while you are living (hence the name federal gift and estate tax). The IRS treats all the wealth you give away in the same way, whether you give it away during life or at death.

The estate tax rates could reach as high as 40 percent for the estates of persons dying in 2014. This means that estate taxes could be one of the largest expenses your estate may pay. It also means that a significant part of your estate may be going to Uncle Sam and not to your loved ones.

If your estate planning goals include minimizing estate taxes and preserving your estate for your heirs or beneficiaries, you need to understand how the estate tax system works, how to estimate your potential estate tax liability , and what techniques are available that may minimize your estate tax liability .

How does the federal gift and estate tax system work?

The estate tax system is a unified system; that is, the gift tax system and the estate tax system are combined. Before 1976, the tax systems were separate. Gifts (i.e., taxable gifts) made during life were reported--and any gift tax owed was paid--on an annual basis. After death, estate tax was imposed only on at-death property transfers.

Since 1976, generally, taxable gifts are still reported--and any gift tax owed is paid--annually. (Generally, you must file a gift tax return and pay gift tax due, if any, by April 15 of the year following the year in which you make a taxable gift.) But, upon death, all gifts are added to your gross taxable estate for estate tax calculation purposes, even though a gift tax return may already be filed and gift tax paid (gift tax paid is deducted from the estate tax owed).

The effect produced by unifying the gift tax system and the estate tax system is (1) lifetime gifts and at-death property transfers are taxed using the same tax rates (under the Unified Tax Rate Schedule), (2) a basic (applicable) exclusion amount can be applied to lifetime gifts and at-death property transfers, and (3) the estate tax imposed at death is computed by adding lifetime gifts to at-death property transfers (this pushes your estate into a higher tax bracket).

Why estimate estate taxes?

Understanding how your estate tax liability is calculated may help you achieve your estate planning goals, such as:

Saving your property for your heirs or beneficiaries

As mentioned, estate tax rates currently reach as high as 40 percent for estates of persons who die in 2014. This means that an large chunk of your estate may go to the federal government instead of your loved ones. If you want to preserve your estate for your heirs or beneficiaries, you need to know how to keep your property transfers from being subject to the estate taxes. This means that you should know what lifetime gifts are taxable gifts and what at-death gifts will be included in your gross estate .

Example(s): *Fred's son Tim goes to a state college. Tim takes out loans to pay for his tuition and works a part-time job to make money for books and other expenses. Fred wants to help his son, so he gives Tim a monthly allowance. Fred is making a taxable gift to Tim that is subject to gift tax (assume no other variables). However, gifts for educational purposes made directly to an educational institution are exempt from gift tax. If Fred paid part of Tim's tuition directly to the college instead of giving the money to Tim, Fred's gift would be tax free. Tim could then use the money he saves on tuition for his other expenses.*

Reducing estate tax liability

Under the unified tax system, every individual is allowed an basic (applicable) exclusion amount that will reduce estate tax liability.

In addition, there are exclusions, deductions, and other credits available that allow you to pass a certain amount of your estate tax free. You need to understand what these exclusions, deductions, and credits are and how they work in order to take full advantage of them.

Example(s): *In 2013, Mary wins $100,000 in the lottery, which she wants to share with her daughters, Denise, Dolores, and Debbie. Assume Mary does not want to use her basic exclusion amount. Mary gives $20,000 to each of her three daughters ($60,000 total). The annual gift tax exclusion allows Mary to give the first $14,000 to each daughter free from tax. Mary incurs tax on $18,000 ($60,000 - [$14,000 x 3]). If Mary gives $14,000 to each daughter in 2013 and then $6,000 to each daughter in 2014, she would be able to give the entire $60,000 tax free because the annual gift tax exclusion can be applied each year.*

Tip: *The* annual gift tax exclusion *is indexed for inflation. Currently, it's $14,000, but this may increase in future years.*

Providing for payment of estate taxes

Generally, your personal representative must pay estate taxes within nine months after your death using assets from your estate. To avoid depriving your beneficiaries of what you intend for them to receive, your estate plan should provide that specific and sufficient assets be set aside and used for this purpose. In addition, these assets should be sufficiently liquid to pay this expense when it is due.

Example(s): *Alison dies, leaving a will. Alison's gross estate includes two homes, one of which she leaves to her son Sam and the other of which she leaves to her daughter Ella. Besides the two homes, Alison's gross estate includes only a small amount of cash, which is used to pay her final expenses. Alison makes no provision in her will for the payment of estate taxes. Her personal representative calculates the taxes owed on her estate, and informs Sam and Ella that the only assets available to pay the taxes are the two homes. After a dispute with Ella, Sam decides to sell the home he received in order to pay for the estate taxes that are owed. Because the taxes are due within nine months after Alison's death, Sam reduces the selling price of the home in order to get the cash in time.*

Tip: *Purchasing a life insurance policy payable to your estate, the proceeds of which would be used to pay estate taxes, may be one solution to this situation.*

Planning for estate tax expense

Although calculating estate taxes can be complex, you should estimate what the amount of the estate taxes may be so that you can arrange to have sufficient funds to pay the tax bill.

Example(s): *Sally had built a substantial estate over her long life. Extremely devout, Sally promised her church that upon her death she would leave enough money to replace the steeple and make other much needed repairs. Sally executed her will and specifically provided for her family and friends. She also felt very satisfied that by leaving whatever remained in her estate (the residuary) to the church, as she had promised, the church would have all the money it needed to make the required repairs. Without calculating what her estate tax liability might be, Sally took a guess and put aside an amount she thought would be sufficient. Sally died. Sally's personal representative calculated the estate taxes owed on her estate. The actual amount owed far surpassed the amount Sally had put aside, so Sally's personal representative had to take an additional amount out of the residuary to make up the difference. The amount left over for the church was only enough to make a few small repairs. The steeple was not replaced, and several larger repairs were left undone.*

Although estimating estate taxes can be complex, don't be overwhelmed. If you proceed step by step, you can do it. The peace of mind that comes with implementing a successful master estate plan should be worth your time and trouble.

What is minimizing estate taxes?

Understanding how the unified tax system works and using the system to your benefit can help you save your property for your beneficiaries and reduce your potential estate tax liability. There is another method you can use to accomplish those goals: the estate freeze . As the name implies, an estate freeze fixes the value of your estate at its present value. This may save estate taxes because no future growth of your assets will be included in your estate when you die.

Estate freezing techniques range from relatively simple (e.g., installment sale) to the more complex (e.g., gift- or sale-leaseback). You need to know what these techniques are and how they are used in order to know which, if any, are best for you. For more information, see Minimizing Estate Taxes .

IMPORTANT DISCLOSURES

Element Insurance Partners does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

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