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How Can I Minimize Estate Taxes?

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In the realm of Exit Planning and Estate Planning it can be important to understand what estate taxes are, know the tools available to help minimize them, and employ those tools to transfer your estate (including your business) to the “objects of your bounty” upon your death. In this article, we will focus on an important area of estate planning for business owners and their families – strategies to help minimize estate taxes when creating such a plan.

What is an Estate?

Before we jump into this important discussion, let’s first define what an estate is. An estate, for federal estate tax purposes, is everything you own or control at death, including life insurance proceeds and jointly owned property. The federal government and most state governments impose an estate tax when two conditions are present: (1) you have departed this earth and (2) your estate is in excess of the estate tax exemption amount available in the year of death (somewhere between $1 million and $3.5 million in the next few years). So, how do you minimize your estate taxes if you fall within these parameters?

First, you must make full use of the available exemption equivalent amount that you can leave at your death without paying taxes. This exclusion also is available to your spouse. With proper planning, a total estate of $2 million to $7 million may pass to children without estate tax consequences (depending on current estate tax law).

The marital deduction is the second primary means to eliminate or reduce estate taxes. This is a total deduction from taxation of all amounts passing from a decedent to his or her spouse (provided the spouse is a U.S. citizen), either as gifts or at death. Even if your estate is worth $50 billion, if you leave everything to your spouse at your death, there are no federal taxes, in most cases.

We’re sure this sounds great to you, and it is, at least at the time the first spouse dies. But there’s a hidden trap. When the surviving spouse also dies, there is no longer a marital deduction on any property previously

passed to the surviving spouse because of the marital deduction. The only “deduction” that remains is the available exemption equivalent amount. In this case, the entire estate tax burden normally falls on the surviving children. For an example of this scenario, let’s take a look at the hypothetical case study of DeWayne and Connie Smith.

The Smiths, in their late thirties, had two young children. Personal property and investments totaled $700,000. Their business was worth $5 million, the equity in their home was $1,300,000, and they each had life insurance of $1 million payable to each other. Their total estate was valued at $9 million.

As their estate was initially structured, there would be no taxes when the first spouse died since the surviving spouse would receive everything. However, when the surviving spouse died, there would be estate taxes between (approximately!) $1 million and $3.5 million.

The couple’s Exit Planning Advisor explained to the Smiths that the estate tax consequence of not doing any further estate planning was to pay significant estate taxes. Both insisted; however, that if DeWayne died first, Connie should receive the benefit of the entire estate to satisfy her lifetime needs. That was more important to them than saving estate taxes. But, then their advisor explained that it was possible for each of them to both save taxes and accomplish that goal.

First, their Exit Planning Advisor recommended that the joint tenancy on all of their assets be severed and the assets be retitled so that each spouse owned approximately $3.5 million of assets in his or her name. The life insurance would be owned by an irrevocable life insurance trust to keep the insurance proceeds from being subject to estate taxes. Under current tax law should death occur within three years of such a transfer, the death proceeds will come back into the decedents estate. One caveat: It is important to work with an experienced estate planning professional when doing this as there can be a hidden trap – “The Reciprocal Trust Doctrine” – that must be avoided.

The Smiths, after equalizing the estates, created wills with trust provisions. (Living trusts work equally well.) The effect of the planning was to transfer as much as possible, without tax consequences, of the spouse’s estate in a family trust for the benefit of the surviving spouse and children. Accordingly, when the first spouse died, (it made no difference who died first, since their estates were equalized – a crucial planning point), the estate exemption amount prevailing at the first spouse’s death (between $1 million and $3.5 million, which varies with the year of death under our current tax law) would go into a trust for the survivor. The surviving spouse could receive all of the income for the rest of his or her life and, as trustee, have significant control over the use of the money in the trust. Yet, for estate tax purposes, only the amount of money owned in his or her name would be includable in the estate when the surviving spouse died. This is the case because the trust created at the death of the first spouse was designed to place enough restrictions on the right of the surviving spouse’s access so that the IRS would not consider the amount in that trust to be includable in the surviving spouse’s estate as well.

The net result? When the first spouse dies, there will be no estate taxes. Instead, the exempt amount ($1 million to $3.5 million) will go into a family trust. If the decedent spouse owned more assets than the exempt amount, the balance would go to the surviving spouse via a provision in the will or trust document, and this

amount would qualify for the marital deduction. So, with proper planning, there is no estate tax when the first spouse dies.

When the surviving spouse dies, estate tax is minimized or eliminated (again, depending on year of death) because the surviving spouse's estate consisted of well less than half of the original estate.

The type of trusts described in this case study can continue for the benefit of the surviving children. The remaining amounts were designed to be distributed to the children at ages Connie and DeWayne deemed appropriate, thereby meeting the couple's estate planning goals.

Conclusion

Estate planning is a process that continues throughout your lifetime. The degree of involvement – or neglect – you pay to this process will be felt by your loved ones long after you are gone. Thorough estate planning should help accomplish these goals:

1. To provide for family income needs, especially those of your spouse and dependent children, after your death.
2. To minimize or eliminate estate taxes.
3. To fuel the growth of your estate outside of your business interests.
4. To provide for a fair, but not necessarily equal, distribution of your estate among your children, both during your lifetime and at death.
5. To preserve your assets from the claims of creditors during your lifetime.

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