REDUCING ESTATE TAXES

If you are unlikely to have more than $11 million ($22 million for a married couple) when you die—or potentially $6 million/$12 million per the next paragraph—then you can skip reading this. If you are among the fortunate few, please read on. We hope you find this informative and beneficial.

Although estate taxes have long been in existence in the United States, they have changed significantly over time. The Tax Cuts and Jobs Act of 2017 increased the lifetime exemption from $5.5 million per person to $11.2 million per person, with this increase scheduled sunset on January 1, 2026. In theory, this means the lifetime exemption should drop back down to about $6 million ($12 million per couple). However, in the last 50 years there has never been a reduction in the lifetime exemption, even due to scheduled reversions such as this. Instead, lawmakers have amended the lifetime exemption higher before such reversions had a chance to go into effect.

All of these law changes can make it difficult to plan for the potential future impact. Below is a brief summary of some of the techniques that our clients have used that you may consider when you next meet with your estate planning attorney.

Annual Exclusion Gifts and Qualified Expenses

In addition to the lifetime exclusion described above, each of us can make an annual gift, currently $15,000 per year free of any gift tax, to anyone. Gifts in excess of this use of part of one's lifetime exemption which means that if one's estate is large enough to be taxed, the tax burden on the excess gift is 40%.

Payments made directly to providers of education and healthcare for services rendered to others is also exempt from gift tax. For example, a parent or grandparent could gift $15,000 per year to a child AND pay for tuition and medical expense all in the same year without paying any gift tax.

Annual exclusion gifts made to minors can be deposited into custodial accounts, irrevocable trusts or 529 plans. Please watch our Knowledge Center video titled "Opening an Account for your Child" to see which option is best for your family.

Charitable Remainder Trusts

Charitable remainder trusts (CRTs) have been used extensively to avoid paying capital gains taxes. The grantor takes a highly appreciated asset and contributes it to the CRT. The CRT makes monthly or quarterly payments to the grantor. Those payments are defined by IRS tables. The longer the term is, the lower the rate. At the end of the trust term, whatever value is left is gifted to the charity named in the trust document. Because the remainder beneficiary is a qualified charity, the trust does not pay capital gains taxes on the sale of the gifted asset. CRTs work best when interest rates are high. For example, in 2000 a client set up a CRT that has paid 11.5%, terminating in 2020.

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Charitable Lead Trusts

Charitable lead (annuity) trusts (CLATs) are used more rarely. Conceptually, it is the reverse of a CRT. A CLAT is used by individuals who wish to give to charities now and minimize the estate tax on wealth transfer to their heirs in the future. The trust setup begins with the grantor making a deposit, typically cash or other assets. The trust then makes quarterly distributions to a qualified charity or alternatively to a donor-advised fund.

At the end of the trust term, the remainder distributes to the named beneficiary, usually the grantor's heirs. The term of the trust and the rate of the charitable distributions can be adjusted to "zero out" any gift tax. Essentially, the present value of the future stream of charitable distributions is set to equal the present value of the projected future distribution to the heirs.

Because of this discounting, CLATs work best when interest rates are low. In 2013, a client set up a "zeroed out" CLAT with a 20-year term and a 4.5% annual charitable distribution. Six years later, the original funds are up 10% after all distributions and costs.

Grantor Retained Annuity Trusts

Grantor retained annuity trusts (GRATs) are used to transfer the future appreciation of an asset out of a grantor's estate to his or her heirs. These trusts are frequently used with appreciating assets such as real estate or pre-IPO stock.

The grantor contributes assets to the trust, retaining a modest minimum annual return stipulated by the IRS. After a period of time, the trust returns value equal to the original contribution to the grantor with the excess distributing to the named beneficiaries. The excess distribution is not considered a gift.
One benefit of a GRAT is that if the contributed asset does not appreciate in value by the conclusion of the term, the asset reverts to the grantor. This means that if the IPO does not happen, for example, then the grantor retains the shares.

Qualified Personal Residence Trusts

Qualified personal real estate trusts (QPRTs) are used to transfer a residence from parents to children over time. These are often used to bequeath iconic vacation homes from one generation to the next while minimizing the taxes due on the transfer. It is important that the trust term be completed before parents die, otherwise the trust collapses back into the estate of the decedent. During the term of the trust, the parents own and occupy the property rent-free until the trust term is completed, at which time the title transfers to the next generation. From that point forward, to the extent that the parents use the property, rent will be paid to the new owners.

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