Objects in the Mirror May be Closer Than They Appear: Why Estate Taxes Still Matter

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The recently passed Tax Cuts and Jobs Act (the "Tax Act") has reduced the federal estate taxes to the point that such taxes currently affect a very small percentage of U.S. citizens and residents. Nevertheless, many individuals and families are still affected by State estate and inheritance taxes, which typically apply to individuals with wealth that falls well below the federal exemption levels. In addition, the federal tax exemption levels are scheduled to reset to significantly lower levels in 2026. Wealthy individuals and families who have worked extremely hard to establish their financial legacy need to know how estate taxes may yet impact them and their beneficiaries.

FEDERAL ESTATE TAX REGIME

The recently passed Tax Act did not repeal the federal estate tax, but rather, increased an individual's lifetime gift and estate tax exclusion amount to approximately $11.2 million in 2018 ($22.4 million per married couple). The Act effectively doubled the exemption amount compared to the prior amount. In addition, the new, higher exemption amount will increase even more each year to adjust with inflation. The top federal estate tax rate is currently 40%.

What this means is that wealthy people and their advisers cannot afford to ignore what is scheduled to happen on January 1, 2026. On that date the doubled exemption amount will expire and the individual exemption amount will fall to an estimated range of $6.5 million to $7 million (twice that for married couples). Unless there is a near certainty of death before January 1, 2026, most estate planning professionals are preparing client documents with this lower 2026 estate and gift tax exemption in mind.

STATE ESTATE TAXES

In addition to planning for federal estate taxes, wealthy clients and their advisers also need to ascertain whether they may need to plan for State estate or inheritance tax. State estate and inheritance tax has been a fluid area of tax law in recent years with many States implementing changes, including the repeal of their estate or inheritance taxes. However, if you are a resident of, or own property in a State that imposes, an estate or inheritance tax, the impact can be significant. This often affects clients whose wealth falls far below the federal exemption levels.

For example, the State of Illinois taxes estates over the threshold amount of $4 million at a top estate tax rate of 16%. A married couple can plan around the $4 million threshold amount to reduce estate taxes, but only if assets are properly titled at the first death or if they have named appropriate beneficiary(ies).

AWARENESS AND PLANNING

Understanding whether you and your family could be subject to federal and/or State estate and inheritance taxes is the first step in addressing what many consider a "voluntary" tax. The tax is often thought of as "voluntary" because such taxes can be minimized and often eliminated with proper planning. Your financial, accounting and legal advisers have plenty of ideas and tools to help you address this situation, many of which are not very complicated.

First, the manner in which you and your spouse have established ownership of your assets could result in estate taxes that could otherwise be easily avoided. While federal law includes a portability concept that allows a surviving spouse (under most circumstances) to use his or her deceased spouse's unused exemption amount, your State law may not.

For example, assume Mr. and Mrs. Brown live in Illinois and have a combined estate of $6 million. All of their assets are owned jointly or name the surviving spouse as the beneficiary. If Mr. Brown dies in 2018, all of Mr. Brown's assets will pass directly to Mrs. Brown. There is no federal estate tax upon Mr. Brown's death because of the high exemption amount ($11.2 million) and unlimited marital deduction for property left to a surviving spouse. There is also no Illinois estate tax when Mr. Brown dies because Illinois also recognizes the unlimited marital deduction for property left to a surviving spouse. However, if Mrs. Brown later dies in 2018, there will be an Illinois estate tax of approximately $456,000. Had Mr. Brown established the ownership of assets with a total worth between $2 million and $4 million in his individual name, and left those assets to Mrs. Brown in a separate trust for her benefit, the Browns could have avoided paying any Illinois estate tax at all. By creating a relatively simple estate plan that includes proper titling of assets and a lifetime trust for each of Mr. and Mrs. Brown, their team of financial, accounting and legal advisers could have added great value – a savings of $456,000 in this example.

Second, whether dealing with federal or State estate or inheritance taxes, awareness and periodic planning meetings among you and your advisers can produce great savings for your family. A thoughtful lifetime gifting strategy-is at the heart of most effective estate plans. For federal law purposes, an individual can gift up to $15,000 to any number of individuals annually without incurring any gift taxes or reduction of her/his estate and gift tax exemption. A married couple can gift $30,000 to any number of individuals (under certain circumstances a federal gift tax return must be filed). For example, a married couple with two children could give each child up to $30,000 for a total of $60,000 without using any lifetime exemption. Gifts can be made directly to individuals or to carefully prepared trusts. In addition, once assets are gifted, all appreciation of the gifted assets as well as the income generated will belong to the recipient of the gift.

One common gifting strategy is to set up an irrevocable life insurance trust that will own insurance on the life of the individual who establishes the trust. Each payment of premium on the life insurance is a gift to the trust, but those premiums typically fall well within the annual exclusion limits. (Imagine the amount of life insurance that can be purchased with a $60,000 annual gift to a life insurance trust.) When the person who established the trust dies, the entire proceeds of the life insurance policy (which is often millions of dollars) will avoid both federal and State estate taxes as long as the trust was properly structured and administered.

In addition to annual exclusion gifts, you can also make unlimited tuition gifts and health care gifts, provided that amounts are paid directly to the institution providing the education or medical care.

Since the increased exemption is scheduled to be cut in half on January 1, 2026, people who have estates that exceed the 2026 projected exemption of $6.5 to $7 million (double that for a married couple) should consider taking advantage of the increased exemption amount before January 1, 2026 by making significant gifts. In other words, the federal government has created a "use it or lose it" scenario because the increased exemptions are scheduled to go away and the Tax Act includes a provision instructing the

IRS to not penalize taxpayers who use any part or all of the increased exemption before January 1, 2026 but die after December 31, 2025, if the exemption does decrease.

The bottom line is a thoughtful and structured gifting program can have an extraordinary impact on reducing estate taxes. Annual exclusion, tuition and medical care gifts are particularly powerful because (1) they do not reduce your lifetime exemption and (2) unlike gifts that use lifetime exemption, they are not included in the final calculation of federal or state estate taxes. Even if gifts are made using lifetime exemption and that causes an estate tax to be due to a State after death, your beneficiaries will still be better off because the tax will have been deferred until after your death and all of the appreciation and earnings after the gift will escape the estate tax.

If you think you may be subject to federal or State estate or inheritance taxes, we encourage you to take the first step of discussing this with your financial, accounting and legal advisers. Doing so may help you better understand of the strategies available to you that can preserve your wealth.

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