Estate Tax: How is it calculated?

by Glen Goland, JD, CFP®
Senior Wealth Advisor, Investment Advisor

The Biden administration is proposing a series of changes to the federal tax system, including a reduction in the federal estate tax exemption. The exemption, and the calculation of the estate tax in light of the exemption, are the subject of much conversation (and confusion) these days. This quarter, we take a look at how the estate tax is computed and discuss some common planning techniques used by families who are concerned about a potential reduction in the exemption.

What is included in your estate?

An individual's gross estate is the fair market value of all cash, securities, real estate, insurance, trusts, business interests, and other assets that he or she owns at death. These interests — and their values — are reported on the schedules of the federal estate tax return. There are different schedules for different property types, including some commonly held joint assets where 50% of the fair market value is included in the gross estate.

How are gifts calculated?

Some of the gifts a taxpayer made during his or her lifetime may be included in the gross estate at death. Here is how that math works in a nutshell: Taxpayers can give up to 15,000 annually to any individual without filing a gift tax return, which is called the gift tax exclusion. If a gift is made that exceeds the exclusion amount, then the taxpayer must file a gift tax return in the year the gift is made, showing the amount gifted above the annual exclusion (this amount is called a lifetime taxable gift). No tax is due upon the filing of this return; it is informational only. At death, these lifetime taxable gift amounts (amounts given above $15,000 to an individual in any one year) are added back into the decedent's gross estate for tax purposes.

How is the taxable estate determined?

The taxable estate is determined by applying deductions against the gross estate. The most common deduction is the unlimited marital deduction, which allows for the estate-tax-free transfer of 100% of assets to a surviving spouse. Other deductions can be taken for funeral costs, final medical bills, outstanding debts, probate/legal fees, and charitable gifts. The federal estate tax exemption (currently $11.7 million) is then applied in order to determine the amount of the estate subject to tax.

For example: Imagine an individual whose only asset at death is a home worth $15 million, and which is carrying a $1 million mortgage. The gross estate would be $15 million. Deductions would then be taken for the mortgage, funeral expenses, probate costs, and the individual's final medical costs. Assuming these deductions totaled $1.5 million, and the decedent died unmarried, estate tax would be due on $1.8 million ($15m gross estate - $1.5m deduction - $11.7m exemption = $1.8m taxable estate).

What if there is a surviving spouse?

The math gets more interesting if our theoretical taxpayer leaves behind a surviving spouse. In that case, no tax would be due, as the $15m gross estate would be reduced by the deductions, which in this case include the unlimited marital deduction, and the taxable estate would be $0. Tax may be due on the estate at the death of the surviving spouse, depending on the then-applicable values and exemptions. There are a handful of procedural hurdles that must be cleared in this case so that the decedent's estate tax exemption is preserved for use at the surviving spouse's death.

The estate tax rate

The federal estate tax rate currently ranges from 18% to 40% depending on the size of the estate, so changes to the exemption can have a dramatic effect on the amount subject to the tax and on the sum total tax due. For unmarried taxpayers, that impact will be felt by his or her heirs at death, and for married taxpayers, the impact will be felt by heirs at the death of the second spouse

How to plan for tax-efficient transfer of assets

The primary way families plan for the estate-tax-efficient transfer of assets is to give those assets away while they are alive. This is often done inside of trusts that are drafted for the purpose of providing for the next generation (and often even subsequent generations). The gifts are made during the individual's lifetime with the intent of using the their estate exemption today (and then accounting for the gift on the estate return as a lifetime taxable gift). The first reason to make a gift like this is to remove the future appreciation of the asset from one's gross estate (making a $2 million gift of stock now only counts as $2 million against the exemption, even if that $2m grows to $4 million by the time the grantor dies). The second reason to make this sort of gift is to give away the exemption amount before the available exemption amount is potentially reduced. This is the focus of a great deal of planning in 2021.

When clients are seeking to give away assets via a trust for the purpose of utilizing the current exemption amount, this takes a handful of common shapes, each of them a different type of irrevocable trust. A **qualified personal residence trust** may be used to gift some real estate interests, a **generation skipping transfer trust** may be used to gift securities or cash to future generations, and an **irrevocable life insurance trust** may be used to transfer insurance policies. Each of these legal structures carries its own unique set of advantages and disadvantages, so it would be wise to consult an attorney if this sort of planning is of interest to you and your family.

The Arnerich Massena team can work with you through this planning process. Our team will help arrange and report on your holdings in a way that helps frame the conversation with your attorney. We are happy to attend meetings with our clients' legal teams in order to ensure that accounts are registered properly, and we work to make sure the appropriate assets are transferred to any trust that is established. We can also model out different cash flow scenarios to help you see how your legal planning impacts your monthly spending.

Please contact our team if this sort of planning is on your mind. Many of the legal and accounting teams we work with are ramping up this planning ahead of 2022, so do not wait to start the conversation.