How to Keep Your Estate Planning a Tax-Free Proposition

JASON NOTTE Feb 28, 2015 8:30 AM EST

NEW YORK (MainStreet) – While considering your estate planning for future generations, forget this year's tax levy and think of the one your beneficiaries will pay years from now.

There are any number of taxes that can turn an inheritance into a burden for beneficiaries. The federal estate tax exemption sits at $5.43 million for individuals and $10.86 million for couples, placing those paying estate taxes firmly in the upper echelons of the Top 1%. But what Uncle Sam doesn't look for, 16 states and the District of Columbia certainly will. Connecticut, Delaware, D.C., Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont and Washington all impose state estate taxes of up to 20% for those worth more than a specified amount. That ceiling is as high as the fed-matching $5.4 million in Hawaii, but dips as low as $675,000 in New Jersey.

That's just what gets taxed before filing time. If an heir happens to have the distinction of living in Iowa, Kentucky, Maryland, Nebraska, New Jersey or Pennsylvania, there's an extra inheritance tax tacked on once the inheritance is received. Wives of heirs are exempt from all of these taxes, as are life insurance payouts, but that's about as kind as each of these plans gets. Descendants are taxed anywhere from 10% to 26% after coming into some money or property. Domestic partners in all of the above states excluding New Jersey are on the hook for inheritance taxes at those rates as well.

Because of the high exemption amounts for state and federal estate taxes, financial advisors suggest focusing on other tax implications with the help of comprehensive advisors who can also function as attorneys and accountants. While Roth IRAs or trusts are sure ways to keep your beneficiaries from losing a bit of their inheritance to taxes, the following are similarly efficient ways to transfer wealth without worrying about estate or income taxes:

1. Life insurance
This is an absolute must, whether you're just trying to reduce the tax hit on your estate or just transfer your money tax free:

“If a large life insurance policy is held by a trust that is structured to be outside of your estate, the death benefit will not be included in your gross estate for estate tax purposes and life insurance proceeds are generally always tax free to the beneficiaries,” says Anthony D. Criscuolo, certified financial planner with **Palisades Hudson Financial Group** in Fort Lauderdale, Fla. “In this case, the beneficiary of the life insurance is the trust, and your loved ones are the beneficiaries of the trust. This also allows you to have some level of control over how trust distributions will be handled based on how you draft the trust document and what discretion you give to the trustee.”

Even if an inherited property or business pushes beneficiaries beyond the estate tax threshold (or even into more minor inheritance tax territory), life insurance can come in handy.

“A policy for the amount of the estate taxes makes it possible for beneficiaries to retain assets rather than selling them in order to pay an inheritance tax,” says Jason Smolen, co-founding principal and estate attorney at **SmolenPlevy** in Vienna, Va.

2. Gifting

No need to wait until you're gone to shelter portions of your estate from the IRS. Gifts to heirs and loved ones before death reduce the size of an estate and can help it limbo beneath estate or inheritance taxes. A person can gift to anyone up to $14,000 (or $28,000 with a spouse) each year without incurring a gift tax.

“However, there's a tax credit that allows giving up to $5.43 million in a lifetime, though you are consuming your lifetime estate credit,” Smolen says. “Among the benefits of giving is an appreciating asset that has been given away grows outside of your estate.”

Depending on what that gift is paying for, there's a chance you can give even more. If the gift is used to pay for higher education or medical expenses, there is no limit on the amount that can be given tax free. This is where we caution Connecticut residents about their state's gift tax, though — the only one of its kind that remains. That lifetime gift tax credit doesn't apply to you, as your state's gift tax threshold halts you at less than 50% of that total.

3. Real estate transfers

This is where things get costly in a hurry. Real estate can represent a huge chunk of assets, especially if there is more than one property involved.

To avoid that hit, Smolen suggests using limited partnerships to transfer real estate and limit the tax value of those assets. Beneficiaries can then be given shares in that limited partnership either directly or in trust. That can discount the value of that real estate and, since there is a lack of control and a minority discount applied in many cases, it reduces the amount of the gift tax exemption excluded.

In fact, Smolen suggests that the secret to avoiding more taxes on that real estate for beneficiaries later is to keep paying them now even if the property is already in the partnership. If that donor is willing to pay the income taxes due on the trust, the payment of such taxes isn't considered a further gift. By paying the tax bill, a donor can reduce his or her estate, all without consuming the estate/gift tax credit.

“Any gift that would work a hardship on the family should be scrutinized,” Smolen says. “There's a joke that, 'You should always fly first class — because if you don't, your children will.'”