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# Minimizing Estate Taxes

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### What is minimizing estate taxes?

The act of giving away your property, either during life or at death, will probably be subject to one or more of several types of taxes (collectively referred to here as estate taxes), either on the federal level, state level, or both. These tax liabilities may be the largest potential expenses you or your estate may have to pay; federal estate tax alone may reach as high as 45 percent of your estate if you die in 2008. This also means that property you intend to go to your loved ones or others when you die may go instead to the IRS or to your state. Therefore, understanding how these taxes can be minimized is vital if you want to preserve your estate for others.

### What are estate taxes?

Estate taxes are actually transfer taxes. Transfer taxes are imposed when you give your property to someone else. This can be done during life (this kind of transfer is called a gift) or at death (this kind of transfer is called a bequest or legacy if you leave a will, and intestate succession if you don't leave a will). There are five transfer taxes that may affect your estate: (1) state gift tax, (2) state death taxes, (3) state generation-skipping transfer tax (GSTT), (4) the federal gift and estate tax, and (5) the federal GSTT.

#### *State gift tax*

Currently, Connecticut, Louisiana, North Carolina, Tennessee, and Puerto Rico impose a gift tax. A gift is a transfer of property you (the donor) make during your lifetime. The person or organization you give to is called the donee. When you make a gift, it is in exchange for nothing or in exchange for property of lesser value (in other words, it is not a bona fide sale). Generally, gifts must be reported, and gift tax paid in the year following the year in which the gift is made (e.g., gift tax on a gift made in 2008 would be due in 2009). If your state imposes a gift tax and you intend to make lifetime gifts, you should contact your state's department of revenue to find out what gifts need to be reported, how to compute the gift tax, and when and how to file a gift tax return.

#### *State death taxes*

State death taxes are imposed on property distributed after your death. You should be especially aware of state death taxes because they may affect even the smallest estates. There are three types of state death taxes: inheritance tax, estate tax, and credit estate tax (commonly referred to as a sponge tax or pickup tax). Every state imposes at least one type. For more information on this topic, see State Death Taxes.

#### *State generation-skipping transfer tax (GSTT)*

Currently, some states impose a GSTT. The GSTT is imposed on property transferred to a family member who is two or more generations below you (e.g., a grandchild or great-nephew). You can contact your state's department of revenue to find out what transfers may be subject to state GSTT, and when and how to file a return.

#### *Federal gift and estate tax*

Generally speaking, the federal gift and estate tax is imposed on property transferred to others either while you are living or at the time of your death. Unlike the individual states which impose at least one type of death tax, and some of which impose a separate gift tax, the federal tax system is unified. In other words, the IRS adds lifetime and deathtime transfers and treats them the same. This is how the unified tax system works:

Before 1976, the federal tax system worked much like that of the states. Gifts made during life (taxable gifts) were reported, and any gift tax owed was paid on an annual basis. After death, estate tax was imposed only on property owned at death (gross taxable estate). Since 1976, generally, taxable gifts are still reported, and any gift tax owed is paid annually (generally, you must file a gift tax return and pay gift tax due, if any, by April 15 of the year following the year in which you make a taxable gift). But upon death, all taxable gifts are added to your

gross taxable estate for estate tax calculation purposes, even though a gift tax return may already be filed and gift tax paid (gift tax paid is deducted from the estate tax owed). The IRS unified the gift tax and estate tax systems so that: (1) you can't avoid estate tax by giving your wealth away before you die, and (2) you pay tax on the cumulative amount of wealth you give away (this pushes your estate into a higher tax bracket).

### ***The federal generation-skipping transfer tax (GSTT)***

Like the state-imposed GSTT, the federal GSTT is a tax imposed on property you transfer to a family member who is two or more generations below you (e.g., a grandchild or great-nephew). The IRS wants to levy a tax on property as it is passed from generation to generation at each and every level. The purpose of the GSTT is to keep families from avoiding estate tax by skipping an intermediate generation. A flat tax rate equal to the highest estate tax rate is imposed on every generation-skipping transfer you make over a certain lifetime amount (\$2 million in 2008).

**Tip:** The GSTT rate is the same as the maximum estate tax rate, and the GSTT exemption is the same amount as the estate tax applicable exclusion amount.

## **How do you minimize estate taxes?**

You can minimize estate taxes by: (1) taking advantage of certain allowable tax exclusions, deductions, and credits, (2) using an estate freeze technique, or (3) employing post-mortem planning.

### ***Exclusions, deductions, and credits***

Under the federal tax system, individuals are generally allowed to make gifts of up to \$12,000 per donee each year gift tax free under the annual gift tax exclusion.

In addition, individuals are allowed to exempt a certain amount of property from the gift and estate tax.

Further, transfers of property between U.S. citizen spouses are fully deductible, as are transfers of property to qualified charitable organizations.

There are many exclusions, deductions, and credits that if effectively used can minimize estate taxes. You need to understand what these exclusions, deductions, and credits are, and how they work in order to take full advantage of them. For more information, see *What Isn't Taxed?*

**Tip:** States also have their own exclusions, deductions, and credits, although they may not be the same as the federal system.

### ***Estate freeze***

An estate freeze is any planning device that allows you to freeze the present value of your estate and shift any future growth (or potential growth) to your successors.

**Example(s):** You give land valued at \$100,000 to your children. Twenty-five years later, you die. The land is valued at \$500,000 on the date of your death, but only \$100,000 is included in your taxable estate because the value of the land froze on the date you gave it to your children.

There are many ways you can freeze the value of property. Estate freezing techniques range from relatively simple (e.g., installment sale or private annuity) to the more complex (e.g., gift- or sale-leaseback). You need to know what these techniques are and how they are used in order to know which, if any, is best for you.

**Tip:** This generally works for state taxes also.

### ***Post-mortem planning***

There are many post-mortem (i.e., "after death") techniques that can help keep the value of your property as low as possible in order to minimize federal estate taxes. There are 10 post-mortem techniques in particular that you

should know about. Even though these techniques are implemented after your death, you should understand each of them now because if you believe your estate might benefit from them, there may be things you need to do now to ensure that your estate will qualify for these elections after your death. For more information, see Post-Mortem Planning.

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