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ESTATE TAX PRIMER FOR MINNESOTANS

Background

We all understand that our government levies taxes on its constituents to fund its services and governance. But there are several types of taxes. The tax most of us encounter everyday is the sales tax. A sale of goods is a time when our governors see it fit to tax us. Perhaps the most famous tax is the income tax – the transfer of money from employer to employee, from borrower to lender (interest) are two common forms of income. Each year, income earners file a return with the IRS to determine how much they owe in light of their level of income for the past year.

The Estate tax is a completely separate tax triggered by an individual's death. This passing of wealth from one person to another – often one generation to another – is currently taxed by our federal government and, in Minnesota and many other states, by the state government.

Current Status of Estate Tax Laws

But estate taxes are not triggered *every* time someone dies. This tax only applies if an estate exceeds a certain threshold amount. Currently, the federal estate tax exemption is $5.34 million per person – any estate below this amount is not subject to the federal tax. The first dollar beyond the exemption is. Minnesota Estate taxes kick in at a lower amount - $2.1 million in 2017. This amount will be increasing to $2.4 million in 2018, $2.7 million in 2019, and to $3 million in 2020 and beyond (until/unless congress acts to change this law). While these are significant estate levels, they come up quickly once you consider what is considered in calculating the number.

Calculating the size of an Estate

It is obvious that in calculating estate size, one would add the values of all assets – bank account balances, portfolio values, retirement account values, real estate equity, etc. However, we do not stop there. One must add the value of death benefits that would be payable upon one's death and add it to the total value of their assets.

This means a person with few assets and a $2 million life insurance policy may have a taxable estate. Also, a family of modest means that owns significant land – perhaps a family farm – also has a sobering estate tax concern. In recent years tillable farmland property in Minnesota has skyrocketed to as much as $7,000 to $9,000 per acre. That means that a modest-sized farm of 200 acres will almost certainly be subject to the Minnesota Estate Tax based on the value of the land alone! In short, despite the exemptions, estate taxes touch a fairly large number of estates.

Planning for Estate Taxes

There are several methods to employ in planning for estate taxes. Which method is most appropriate depends on several variables: estate size, your goals, willingness to give during one's lifetime, etc. Between a married couple, however, the use of Revocable Living Trusts can quickly serve to double the smaller state exemption. In other words, a couple can spend a few thousand dollars to shelter up to $4.2 million – rather than $2.1 million – in Minnesota. For a $2.5 million estate, this is an estate tax saving of nearly $75,000 Minnesota alone!

If your estate approaches $2 million, please consider consulting with a good attorney to learn more about your specific situation.

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GIFT TAXES FOR MINNESOTANS

When considering estate tax planning, gifting can play a very important roll. The use of gifting to reduce the size of an estate – thereby reducing an estate tax bill later – is fairly simple, and powerful. But it is important to understand the rules to use gifting most efficiently. There is both a Minnesota and Federal gift tax. Here is an overview of how each works.

New Minnesota Gift Tax

The Minnesota gift tax is brand new – it came into effect for any gift made after June 30, 2013. There is an annual exclusion to this tax currently at $14,000. In addition, there is the equivalent of a $1 million lifetime exemption. So you can give a gift of $14,000 or less without being required to file a gift tax return. Even if you give a gift in excess of this amount, you may need to file a return but you still won't have to pay a tax if the gift is less than $1 million.

The "Lifetime" part of the exclusion means that Minnesota Revenue will keep track of your gifts over your lifetime. Once you've given more than $1 million, each gift that you give (that is above the annual exclusion) will be taxable in Minnesota. The rate of the Minnesota gift tax is 10%. If a gift tax is due, it is the Donor (giver of the gift) who must file the return and pay the tax. Of course, if the donor fails to do so, the Donee (the receiver of the gift) will be personally liable for paying the tax.

While many folks will use gifting as a planning tool to reduce the possible estate tax liability of an estate, it is important to note that the new law passed in Minnesota in 2013 considers taxable gifts made within 3 years of one's death are still included in his or her estate for estate tax purposes.

The Federal Gift Tax

Minnesota's gift tax law is similar to the federal law in many ways. Federally, there is also a $14,000 annual exclusion amount. The federal laws, however, offer a lifetime exemption of $5.35 million (2014) – much larger than Minnesota's $1 million exemption.

Using Gifts as a Planning Tool

If you do some planning ahead, the use of the $14,000 annual exclusion can be a very powerful tool. For a married couple with 3 children, each spouse could make this annual gift to *each* child *each* year – reducing the joint estate by as much as $28,000 per child, or a total of $84,000 per year without any gift tax consequences.

Sometimes, it makes sense for folks to give gifts that exceed the annual exclusion. If we cross this threshold, the giver of the give must file a state and federal gift tax return. This does not always mean that there will be a tax due, however. Gifts that exceed the annual exclusion amount, but that are cumulatively below the lifetime exemptions from gift taxes at the state ($1 million) and federal ($5.35 million) levels, will result in no tax due. Don't forget, though, that these taxable gifts could be included in the estate for estate tax purposes in Minnesota if they are made within 3 years of the date of death!

For example, if I transfer a lake home worth $350,000 to my child, it is a taxable gift (because it is above the annual exclusion amount). Therefore, I will need to file a gift tax return with Minnesota Revenue and with the IRS. Although I have to file gift tax returns, there will not be any gift tax due because my $1 million exemption in Minnesota, and my $5.35 million federal gift tax exemption will cover my gift, That gift would leave me with exclusion amounts of $650,000 in Minnesota and $5 million federally for the duration of my life. If I later give beyond these amounts, gift taxes may then be due.

Of course, none of this discussion applies when a gift is given to your spouse or to a charity – as these are tax exempt entities. Like estate tax laws, the results of gift tax laws can vary depending on each unique circumstance. Therefore, it is important to consult with trusted advisors – estate planning attorneys, CPAs, financial advisors – before implementing a gifting plan.