Estate Planning Today:
ATRA*cadabra* and the Magic of A Flexible Design

Guest authored by:
Rob Vigoda,
estate planning attorney
and Partner in the
Boston law firm of
Rubin and Rudman LLP

The enactment of The American Taxpayer Relief Act of 2012 (ATRA) on January 2, 2013, ushered in a new era for estate planners and their clients. The uncertain fate of the federal estate tax that made planning difficult during the previous eleven years under the Bush tax cuts regime was replaced with a permanent gift and estate tax. Despite the reality of a permanent tax, generous transfer tax exemptions, lower rates of tax and the ability of married couples to maximize the use of their exemptions as a single unit has lessened (or even eliminated) the impact of the federal gift and estate tax for all but a small fraction of American families.

Of more relevance to many families is the other, perhaps less publicized impact of ATRA on active estates and funded trusts. Families who choose to utilize trusts in their planning, either because they are still likely to owe estate tax or wish to create trusts for non-tax purposes, face the specter of higher income taxes on income, capital gains and net investment income accumulating in the trust. Reducing income tax without incurring estate tax is possible with proper planning, but it requires flexibility be incorporated into the estate plan and that trust investments be closely monitored during trust administration. Nowhere is this more evident than planning for married couples who may be subject to federal estate tax on the surviving spouse's death, and who wish to maximize the inheritances of their descendants.

Among the challenges faced by planners is motivating clients to update their plans to address the estate and income tax changes brought by ATRA. The client with a modest size estate may not be at risk of owing a federal estate tax, but may have existing trusts with outdated marital deduction and credit shelter funding formulae which may result in unintended consequences. Those with moderate sized estates will require plan documents that minimize estate tax exposure and incorporate income tax planning. At the other end of the spectrum, the high net worth client will still be well-advised to engage in lifetime gifting to maximize the transfer of wealth. Unlike the end of 2012, there is no threat of losing beneficial exemptions or exposing estates to higher tax rates to spur such clients to action.

CHANGES TO THE FEDERAL ESTATE AND GIFT TAX

The following changes to the federal estate and gift tax have a significant impact on estate planning post-ATRA:

• First and foremost, permanence. It will now require an act of Congress (and approval by the President) to repeal the federal estate and gift tax. There does not appear to be any appetite in Washington to reignite the battle over repeal of these taxes. For planning purposes it should be assumed that the status quo will remain in place for the foreseeable future.

Trusts are effective vehicles for transferring and protecting wealth; however this is not the case for accumulating income and capital gains when it comes to income tax.

• Limited applicability to American taxpayers. With unified estate and gift tax exemptions of $5.34 million per taxpayer ($10.68 million for a married couple), these taxes are now irrelevant to 99% of Americans and only affect the richest of the rich. The exemptions rise each year with a cost of living increase built into the law ($90,000 in 2014 and a total of $340,000 to date).

• A relatively low rate of tax once the exemptions are exceeded. If the Bush tax cuts had expired at the end of 2012 as scheduled, the estate and gift tax rate would have reverted to 55%. Under ATRA, the rate on estates and gifts for transfers in excess of the exemptions is 40%.

• The ability of a married couple to utilize both exemptions ($10.68 million in 2014) regardless of how assets are owned. The surviving spouse may now use the unused exemption of the previously deceased spouse (the so-called DSUE or deceased spousal unused exclusion) through a concept called portability. Portability effectively doubles the exemptions for married couples regardless of how assets are owned on the death of the first spouse. Under prior law, to fully use both exemptions each spouse had to own assets in his or her own name equal to at least the exemption amount not including jointly held property. The surviving spouse may use the DSUE to shelter either lifetime gifts or estate tax at death.

A BRIEF PRIMER ON THE INCOME TAXATION OF TRUSTS

Trusts are effective vehicles for transferring and protecting wealth; however this is not the case for accumulating income and capital gains when it comes to income tax. Compressed rate brackets mean that trusts reach the highest income and capital gains rates with taxable income as low as $12,150. Effective in 2013, here are the increased and additional taxes that make the compressed rate brackets all the more painful:

- The top rate on ordinary income increased from 35% to 39.6 %.
- The top rate on long-term capital gains increased from 15% to 20%.
- The tax on undistributed net investment income (UNII) of 3.8 %

(this tax was enacted as part of the Affordable Care and Patient Protection Act, but became effective in 2013 along with the ATRA tax law changes noted above).

A commonly shared goal among married couples is to maximize the after-tax inheritances of their descendants. The path they must take to get there will vary significantly as a result of ATRA, and is best illustrated by describing planning considerations for three cohorts of couples.

By comparison, individual taxpayers become subject to the highest ordinary income and capital gains tax rates with taxable income of $400,000(single filers), and $450,000 (married joint filers). The 3.8% tax on UNII applies to individuals if adjusted gross income exceeds $200,000 for single filers, $250,000 for joint.

THREE PLANNING SCENARIOS

A commonly shared goal among married couples is to maximize the after-tax inheritances of their descendants. The path they must take to get there will vary significantly as a result of ATRA, and is best illustrated by describing planning considerations for three cohorts of couples. The first couple is modestly wealthy, with assets worth between $1-5 million. The second couple is moderately wealthy with assets between $5-10 million. The third couple is a high net worth couple with assets significantly in excess of $10 million.

- **The modestly wealthy couple.** This couple would appear to have won the federal estate tax lottery under ATRA. With $10.68 million of combined exemptions, and the ability to use portability, a simple "I love you" will under which all assets pass outright to the surviving spouse, avoids estate tax and allows for a basis step up on the death of the surviving spouse. However, there still may be reasons for incorporating trusts in an estate plan for this couple:

The couple may live in a state, such as Massachusetts, that has its own estate tax. Many state estate tax exemptions are much lower than the federal exemption ($1 million in the case of Massachusetts), making avoiding state estate tax more difficult. In order to minimize the state estate tax, the couple will want to take advantage of both spouses' exemptions, particularly since portability is not yet available for state estate tax purposes. imposition of the state estate tax.

• In a second marriage, a spouse may be uncomfortable having all of the marital assets pass to the surviving spouse for fear that he or she will disinherit the deceased spouse's children from the first marriage. In this case a trust benefiting the surviving spouse can be funded to ensure that trust assets will ultimately pass to the children after the death of the spouse.

• Beneficiaries may be spendthrifts who need a trust arrangement where trust assets are managed and distributed to them for their needs over their lifetimes. Similarly, beneficiaries may involuntarily put their inheritances at risk through exposure to judgment creditors or property settlements in divorce, which may be avoided if their inheritances are left in a trust over which an independent trustee exercises discretion.

At best, outdated formula bequests over-complicate a plan with no corresponding benefit. At worse, they have the unintended consequence of disinheriting the surviving spouse and increasing the capital gains tax when trust assets are inherited by children by foregoing the basis step up.

If a trust is appropriate for a modestly wealthy couple, dispositive and administrative provisions should be drafted flexibly to allow the trustee to distribute trust accounting income (e.g. interest, dividends, rents and royalties) as distributable net income (DNI) to a trust beneficiary who is in a lower income tax bracket than the trust. If the trust instrument and state law governing the trust allows, capital gains and the tax on UNII may also be taxed to the recipient beneficiary at lower rates.

Proper planning for the modestly wealthy client also entails reviewing existing wills and trusts which may contain formulas for funding trusts on the death of the first spouse that were intended to minimize estate tax under outdated estate tax laws. A typical formula was to fund a discretionary credit shelter trust for the children (which usually included the spouse as well) equal to the exemption in effect on the death of the predeceased spouse, with remaining assets passing as a marital bequest either outright or in trust for the exclusive benefit of the surviving spouse. Formula provisions in wills and trusts drafted more than ten years ago when the Federal exemption was $1 million were based on very different assumptions concerning the division of assets between the credit shelter trust and the surviving spouse. A spouse with $5 million of assets assumed that $1 million would fund the credit shelter trust, and $4 million would pass to or for the exclusive benefit of the spouse. Under ATRA with this formula the entire $5 million will fund the credit shelter trust and nothing will be held for the exclusive benefit of the spouse. At best, outdated formula bequests over-complicate a plan with no corresponding benefit. At worse, they have the unintended consequence of disinheriting the surviving spouse and increasing the capital gains tax when trust assets are inherited by children by foregoing the basis step up.

The moderately wealthy couple. This is the "tweener" couple, caught between the rock of a potential federal estate tax on the death of the surviving spouse and the hard place of incurring potentially avoidable income tax on trust income, capital gains and UNII. The moderately wealthy couple has an estate that does not yet exceed $10.68 million, but which over time (by the time the surviving spouse dies) could.

• This couple would do well to remember two basic principles of estate planning:
Estate tax can be avoided on the death of the first spouse by utilizing the unlimited marital deduction for assets passing to or for the benefit of the surviving spouse. This defers federal estate tax on the couple's assets until the death of the surviving spouse. It is the effective use of both spouse's exemptions that will determine if an estate tax will be due at that time.

• Assets owned in the gross estate of a decedent receive a stepped up basis for income tax purposes equal to the fair market value of the assets at death, whether or not an estate tax is owed.

Before portability, these principles were mutually exclusive. Assets had to be excluded from the gross estate of the surviving spouse so that the estate of the first spouse to die could avail itself of the exemption. As such, there would be no basis step for the exempt assets on the death of the surviving spouse. If the exempt assets appreciate in the period between both deaths, descendants would inherit assets with a low basis which would be subject to capital gains tax when sold.

Portability allows the assets of the deceased spouse to pass outright (or in a trust that qualifies for the Federal marital deduction) to the surviving spouse without wasting exemption. The surviving spouse simply tacks on the DSUE of the deceased spouse to his or her exemption. When the surviving spouse dies, all of his or her assets, including those received from the deceased spouse, will benefit from a basis refresh, enabling descendants to minimize the capital gain (and potentially avoid the UNII tax).

Although portability provides a moderately wealthy couple with much-needed flexibility, it does not replace proper planning. The portability exemption is frozen at the remaining unused exemption in place when the first spouse dies.

Although portability provides a moderately wealthy couple with much-needed flexibility, it does not replace proper planning. The portability exemption is frozen at the remaining unused exemption in place when the first spouse dies. There are no cost of living adjustments to the DSUE. If 1) assets of the predeceased spouse which passed to the surviving spouse appreciate greater than the DSUE by the time of the surviving spouse's death, and 2) the surviving spouse's estate as augmented by such appreciated assets exceeds the DSUE and her own exemption, the excess will be subject to an estate tax at 40% (or higher if the surviving spouse dies a resident of a state with its own estate tax).

It is impossible to know with certainty what the composition and value of the surviving spouse's estate will be at the time an estate plan is prepared.

It is impossible to know with certainty what the composition and value of the surviving spouse's estate will be at the time an estate plan is prepared. If the planner knew with certainty that the combined DSUE and exemption of the surviving spouse would avoid the estate tax he would choose portability and claim the basis step up. If there is a high risk of owing a federal estate tax, he might instead opt to forego the basis step up and fund a bypass trust to minimize the more expensive tax (40% estate tax vs 23.8% capital gains and UNII tax). In advising his clients, the planner should consider:
The likelihood that appreciation of marital assets will expose the estate of the surviving spouse to estate tax (favors bypass trust).

- Composition of marital assets
- Certain assets, such as qualified retirement plan accounts, do not qualify for a basis step up (favors bypass trust).
- Whether the inherited assets will be retained by the recipient, such as an heirloom vacation property, closely held business or family farm (favors bypass trust).
- Whether inherited assets will have a low basis with the likelihood of owing no or a relatively small estate tax (favors portability).
- The likelihood that the surviving spouse's estate will be subject to a state estate tax (favors bypass trust).

It will be easier to consider these factors at the death of the first spouse. For this reason, it may be preferable to defer the decision about whether to minimize estate tax or income tax until this time. There are two approaches to planning for the moderately wealthy couple that offer this opportunity: cascading disclaimers and QTIP marital trusts.

- A disclaimer is a decision by the surviving spouse made within nine months of her spouse's death to forego an entitlement (in this case a bequest from the deceased spouse under his will or trust), with the result being that the bequest will pass to a cascading series of takers in default. Typically, the cascading takers in default of an outright bequest to the spouse will be a marital trust for the exclusive benefit of the spouse, and then a discretionary spray trust for the spouse and descendants. A disclaimer by the spouse of the outright bequest will fund the marital trust, and a further disclaimer of all or a portion of the marital trust interest will fund the spray trust.

All three forms of inheritance by the surviving spouse have different tax consequences to the recipients of assets after the surviving spouse's death. The outright bequest will rely on portability to reduce Federal estate tax and will allow a refresh of the basis of the inherited assets on her death. Assets in the spray trust will avoid estate tax in the estate of the surviving spouse regardless of how much they appreciate, but they will not receive a basis step up. Assets disclaimed into the marital trust can be treated either way based on tax elections made by the personal representative of the deceased spouse.

• A QTIP marital trust may be an option in a cascading disclaimer approach, or can be a stand alone trust into which all of the deceased spouse's assets pass on death. It is a trust for the exclusive benefit of the surviving spouse during her lifetime, and requires that all income be distributed to the spouse at least annually. Typically an independent trustee has discretion to distribute trust principal to the spouse as well. If the personal representative of the deceased spouse makes an election to claim a federal marital deduction for assets passing to the QTIP marital trust, the surviving spouse will use the DSUE of the deceased spouse and assets in the QTIP marital trust will receive a basis step up in the estate of the surviving spouse. If no election is made, assets in the QTIP marital trust will be excluded from the taxable estate of the surviving spouse (including post-death appreciation) but at the expense of foregoing the basis step up.

For the high net worth (HNW) couple, it's deja vu all over again under ATRA. They will have estate plans that incorporate the flexibility of disclaimers and QTIP marital trusts, and their trusts should allow for distributions to beneficiaries that tax them on trust income and capital gains.

The decision about which approach to use must also take into account the circumstances of the married couple. Will the surviving spouse have the financial sophistication, clarity of mind and the necessary legal and tax advice on the death of her spouse to make the right disclaimer decisions? Or, should those decisions be delegated to a third party personal representative to make elections under the QTIP marital trust approach?

The high net worth couple. For the high net worth (HNW) couple, it's deja vu all over again under ATRA. They will have estate plans that incorporate the flexibility of disclaimers and QTIP marital trusts, and their trusts should allow for distributions to beneficiaries that tax them on trust income and capital gains. However, if they plan appropriately during life, the need for trust planning from a federal estate tax perspective is less important than for the moderately wealthy couple. The simple reason for this is that lifetime gifting is the most tax-efficient way of transferring wealth to younger generations. It was true before ATRA, and remains so today.

The HNW couple should not preserve their exemptions for use at death. The ability to fund irrevocable grantor trusts while living using their lifetime gift tax (and for this couple their generation skipping transfer tax, or GSTT) exemptions avoids estate tax and the GSTT tax on post-gift appreciation and allows for the tax-free growth of investment assets in the trust because the grantor of the trust will be taxed as the owner of the trust assets. These considerations outweigh the inability to step up the basis of gifted assets. If estate and GSTT exemptions are exhausted at the first spouse's death, there are no longer federal transfer tax reasons for his or her plan to include funded trusts.

• Income and capital gains in non-grantor trusts funded with lifetime gifts or testamentary trusts funded at death will be taxed at the trust's high rates. Basis step up planning will remain an important consideration for this cohort of clients, but may be more challenging. Presumably, it will be more difficult to find a HNW trust beneficiary who is in a lower income tax bracket than the trust.

Popular techniques for transferring wealth to minimize federal transfer gift tax (gift, estate and GSTT) have all been the targets of taxpayer unfriendly reform over the past several years.

• Popular techniques for transferring wealth to minimize federal transfer tax (gift, estate and GSTT) have all been the targets of taxpayer unfriendly reform over the past several years. If the proposals become law, they could curtail the tools available to the HNW couple for maximizing wealth transfers to multiple generations of descendants. These techniques include:

• <u>Grantor Retained Annuity Trusts (GRATs).</u> A GRAT is one of the most tax-effective tools for transferring an appreciating asset to children with little or no gift tax consequences. Proposed changes would require that the grantor survive the transfer by ten years, and that more than a de minimis gift be made when the trust is funded.

• <u>Valuation discounts for transfers of closely held business interests and other difficult to value assets.</u> Gift tax is assessed on the fair market value of the gifted asset. Discounts of between 25% and 40% are typical in valuing closely held or fractional interests, which reduce the taxable gift. Proposed changes would eliminate discounts for transfers between family members.

• <u>Installment sales to irrevocable grantor trusts.</u> In this estate freeze technique, an appreciating asset is sold to an irrevocable grantor trust for a promissory note. Any appreciation in value above the interest paid on the note inures to the benefit of the trust beneficiaries. This is an effective way of funding a GSTT exempt trust for the benefit of children and more remote descendants. Under the proposal, the grantor's estate would include the appreciated value of the trust assets.

• <u>Dynasty trusts.</u> Dynasty trusts are exempt from the GSTT and last for multiple generations of beneficiaries. The result is that distributions can be made to skip persons such as grandchildren without the payment of a GSTT, and trust assets avoid estate tax until the trust terminates. In certain states dynasty trusts are perpetual. The proposed changes limit their duration to ninety years. The effective date of the proposed changes would be from date of enactment, making it likely that if any of the techniques are incorporated in a plan before then they would be grandfathered from any change in the law. Therefore, where appropriate these techniques should be utilized sooner rather than later.

If the opportunity to reduce estate and gift taxes disappear, procrastination and not magic will be to blame.

ATRA has brought relief to some, and more headaches to others. Modestly wealthy clients can focus less on estate tax considerations, and more on the non-tax purposes served by trusts. In doing so, income tax minimization will be important to avoid trapping income and gains in the trust at higher rates. The moderately wealthy clients must weigh the potential for owing federal estate tax against minimizing the capital gains and UNIT tax on inherited assets. The HNW clients have all of the same challenges they had before ATRA. With the added threat of taxpayer unfriendly tax reform, they also have the most to lose by inaction. If the opportunity to reduce estate and gift taxes disappear, procrastination and not magic will be to blame.

<u>About Rob Vigoda</u>

Rob joined Rubin and Rudman's Trust Department in March 2009, representing some of the most financially successful entrepreneurs and families in the country. His proactive approach to identifying and implementing practical strategies has preserved after-tax wealth and ensured business continuation for many entrepreneurs and their families. Rob has practiced estate planning, estate administration, and business succession law for over 30 years.