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Estate Planning Update for 2014

Leveraging ATRA for Asset Protection Planning and Gifting Opportunities

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Estate Planning Update for 2014

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Fiscal Cliff Legislation as it Relates to Estate Planning

- Formally known as the “American Taxpayer Relief Act.”
- 40% maximum rate for estate, gift and GST taxes.
- $5.12 million unified exemption indexed for inflation (expected by the federal government to rise to approximately $5.25 million in 2013).
- Stepped-up basis.

Fiscal Cliff Legislation as it Relates to Estate Planning

- State estate tax deductibility.
- Spousal portability.
- Technical provisions of the 2001 Tax Act relating to the allocation of GST exemption, the inclusion ratio, conservation easements and the extension of time to pay estate taxes under section 6166 would be made permanent.

Is This Good or Bad for Estate Planning Attorneys?

- Higher Exemption makes planning for the estate tax unnecessary for the vast majority of families.
- Higher Exemption reduces the need for common “advanced planning” techniques such as fractional gifting, QPRT’s, ILIT’s, and CRT’s.
- Lack of motivation for clients to get their estate planning completed or updated?

It’s a Good Thing . . .

- Most clients are not motivated by the estate tax.
- Clients are motivated by a general desire to “get their affairs in order,” making sure that their wishes are carried out upon incapacity or death, making sure their loved ones are “taken care of,” and making it as efficient and inexpensive as possible.

It’s a Good Thing . . .

- While elimination or mitigation of the estate tax is certainly part of the overall goal, it’s simply one piece.
- Clients will be happy their plans are simpler.
- No need to let the estate tax tail wag the estate planning dog.
- Higher exemption and permanent portability frees up estate planning.

Impact on A/B Planning

- For generations, the cornerstone of estate planning for married couples.
- Three reasons to do an A/B or A/B/C trust:
  - (1) Estate tax purposes: preserving the deceased spouse's estate tax exemption.
  - (2) "Control issues": preventing the surviving spouse from disinheriting the children in favor of the tennis instructor or the belly dancer.
  - (3) Possible creditor protection for surviving spouse.

Impact on A/B Planning

- Higher exemption combined with permanent portability eliminates the need for an A/B or A/B/C Trust for estate tax planning purposes for the vast majority of families.
- Simplifies the ongoing trust administration upon the death of the first spouse:
  – No need to file fiduciary tax returns.
  – No issues with funding the Bypass trust with non-ideal assets such as the personal residence.

Impact on A/B Planning

- Simplifies the ongoing trust administration upon the death of the first spouse (*continued*):
  – The entire trust is still revocable / amendable after the first spouse dies (good and bad, depending upon the circumstances).
  – More in line with the expectations of the client
  – "Everything stays the same."
    - Still only file personal tax returns, use SSN as Tax ID Number, all the same "rules."

Impact on A/B Planning

- Reduces the liability for the surviving spouse in administering / spending the trust assets.
- Surviving spouse has greater power over remainder beneficiaries: carrots and sticks to influence behavior.
- Reduces malpractice exposure on the part of the drafting attorney and the attorney who handles the trust administration upon the death of the first spouse.

Impact on A/B Planning

- Unless there are “control issues” or creditor protection issues, consider drafting A trusts or disclaimer trusts instead of A/B trusts when the estate is lower than one spouse’s exemption.
  - Discussion with clients, focused on the non-estate tax reasons to execute an A/B trust.

Impact on A/B Planning

- An “A Trust”:
  - Does not have any provision for the split into two or more sub-trusts upon the death of the first spouse.
  - The trust simply continues as a “pass-through” revocable grantor trust for the benefit of – and under total control by – the surviving spouse.
  - All assets will be part of surviving spouse’s estate upon his/her death.

Impact on A/B Planning

- A "Disclaimer Trust":
  - Upon the death of the first spouse, all of the assets will be titled to an "A Trust" (commonly known as a "survivor's trust") except that any asset the surviving spouse disclaims within nine months of the first spouse's date of death will be funneled to a "B Trust" (commonly known as a "bypass trust").
  - Gives the surviving spouse the option to keep the trust as an "A Trust" or to split it into an "A Trust" and "B Trust."

Impact on A/B Planning

- If the determination is made not to draft a mandatory A/B trust, a disclaimer trust is probably a better option over an A trust.
  - More options.
  - What’s the harm?

Impact on A/B Planning

- Inform past clients of change in thinking, invite them to consider restating their A/B trusts as disclaimer trusts.
  - It's okay to change your thinking / strategy as long as you keep your past clients informed.
  - Clients understand that the law is in flux and will appreciate your effort to keep them informed.
  - Might be new revenue, but more importantly, an opportunity to stay in contact with your clients and maintain good will.

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Permanent Portability

- Prior to the fiscal cliff legislation, portability was only scheduled to be effective for deaths occurring in 2011 and 2012.
- The fiscal cliff legislation makes portability permanent for all deaths occurring in 2011 and beyond.
- Allows the surviving spouse to “claim” the deceased spouse’s unused estate tax exemption without any prior planning.

Permanent Portability

- “Deceased Spousal Unused Exclusion Amount” – “DSUEA.”
- Example: Husband dies in 2011 with a $4 million estate. He leaves $2 million to his children directly and the rest to his surviving spouse. He left $3 million worth of exemption “on the table.” Wife may file a 706, elect portability, and add his $3 million exemption to her exemption. If she dies when the exemption is $5 million, she will actually have an $8 million exemption.

Permanent Portability

- Must file a timely 706 even if it is not otherwise required.
  - Warn clients about this deadline in your engagement letter?
  - Form 4768 extension.
- Only applies to the “last” deceased spouse of the surviving spouse.
  - Addresses the “black widow” or “black widower” problem.

Permanent Portability

- Particularly helpful with non-trust assets such as IRA's, 401(K)'s, and other retirement accounts.
- If a significant portion of a client's wealth was tied up in non-trust retirement accounts, there was a danger that the bypass trust would be underfunded.

Permanent Portability

- Issues of naming a bypass trust or QTIP trust as a beneficiary of a retirement plan on the death of a first spouse:
  - What if the owner of the account is not the first to die and the beneficiary designation is not updated?
  - Personalized beneficiary designation form?
- Issues of a QTIP Trust owning a retirement plan:
  - Definition of “income” to preserve the marital deduction.

Permanent Portability

- With permanent portability and a much higher estate tax exemption, naming the spouse as the primary beneficiary does not risk underfunding the bypass trust.
  – One exemption might cover the whole estate.
  – Portability could be utilized to cover non-trust assets that will be part of the surviving spouse’s estate.

Permanent Portability

- Can “rescue” assets that were never titled to the trust but perhaps should have been.
  - Better than relying on A/B planning in this regard.
- Can “rescue” estates where there was no planning or insufficient planning.

Leveraging ATRA– Asset Protection

Following ATRA 2012, fewer clients will be subject to federal estate tax, but all clients need asset protection planning.

Current divorce rate in the United States is 40% to 60%.

34% of new businesses fail in the first 2 years.

56% of new businesses fail in the first 4 years.

The impact of a failed marriage or failed business and the ensuing divorce, personal or business (or both), will likely deplete an estate far worse than a marginal increase in the exemption amount.

Leveraging ATRA – Asset Protection

The increase in exemption amount does nothing to alter the fundamental risks of life.

All of the sophisticated techniques that we have use for estate tax planning remain very relevant for asset protection planning.

-FLPs

-LLCs

-Grantor Trusts (and Sales to IDGTs)

Leveraging ATRA – Asset Protection

Proposals By Current Administration Will Not Affect These Planning Techniques for Asset Protection Planning Purposes

Administration Proposes to:

-Eliminate Valuation discounts (FLPs & LLCs)

-Include Grantor Trusts in Grantor's Estate for FET purposes.

If enacted, neither of these proposals would affect the efficacy of these techniques for asset protection planning.

Leveraging ATRA – Asset Protection

Buyer's Remorse?

Between the threat of a 1M exemption and the possibility of elimination of valuation discounts, many clients formed and funded FLPs and LLCs.

Now with some permanency in the exemption amount, some clients may be tempted to unwind these transactions because these entities add a layer of complexity and cost they would rather not have.

Leveraging ATRA – Asset Protection

BIG MISTAKE

These entities were never designed solely to avoid estate tax (economic substance anyone?)

- -Asset Protection
- -Succession Planning
- -Controlling Irresponsible Heirs

PLUS: Unwinding an entity could inadvertently give a potential creditor an argument the entity was a sham or alter ego.

Leveraging ATRA – Asset Protection

Asset Protection With a Twist – Income Tax Planning

We now have the greatest gradation of individual federal income tax rates since 1986.

FLPs and LLCs now present greater opportunities for shifting income from higher bracket taxpayers within the family to lower bracket taxpayers within the family, especially when the 3.8% surcharge is considered.

Original purpose of FLPs was income shifting, which gave rise to the family partnership rules in IRC § 704(e).

Leveraging ATRA – Gifts

The Old School Turned on Its Head

Three Types of Clients:

1. Moderately Wealthy Clients (MWCs);
2. Bubble Clients (BCs); and
3. High Net Worth and Ultra High Net Worth Clients (HNWCs).

Leveraging ATRA – Gifts

Gift Strategy Very Much Dependent on Type of Client

MWCs – not subject to federal estate tax and probably never will be. Estate tax planning is not and should not be on their horizon, but income tax planning may be appropriate.

Most MWCs would be better off not making lifetime gifts, but instead retain the asset and obtain a stepped-up basis at death.

MWCs should be concerned about asset protection planning, so some intermediate planning techniques are appropriate, but MWCs must be educated on the need for such planning.

Leveraging ATRA - Gifts

MWCs should have their estate plans reviewed to:

1. Insure POAs reflect increased annual exclusion and permit increased amounts as the annual exclusion increases.

2. Simplify estate plans.

3. Review and potentially repurpose insurance coverage.

4. Incomplete gift strategies, i.e. DAPTS, may be appropriate for asset protection purposes because the asset remains in the estate to obtain a step-up in basis.

Leveraging ATRA - Gifts

BCs – potentially subject to estate tax if their estate increases in value, but need to consider client, i.e. 85 year widow with a 4M estate or a 50 year old couple with a growing business worth 8M.

Income tax planning a must.

Asset protection planning a must.

BCs will need some intermediate planning and potentially advanced planning such as an inter-vivos trust with spousal access rights or an intentionally defective beneficiary trust.

Leveraging ATRA - Gifts

HNWCs – same estate tax planning techniques as before, but with a twist – income tax planning.

5% of the taxable estates have paid 50% of the estate tax.

HNWCs should view this period as the eye of the storm. HNWCs now know that permanent repeal of the estate tax is gone and the estate tax rate is now 40%.

Leveraging ATRA - Gifts

What is up for grabs?

Repeal/abolition of:

Valuation discounts;

Short term GRATS; and

Exclusion of grantor trusts.

Elimination of these planning techniques for HNWCs would have a far greater impact than the 40% federal estate tax rate.

Leveraging ATRA - Gifts

HNWCs – Top Off the Tank

Many HNWCs utilized their full exemption in 2012. It is time to top off the tank with the inflation adjusted increase, which should be done annually.

Update POAs to insure POAs permit maximum annual exclusion gifts, together with any increase in annual exclusion gifting limits.

Update POAs to provide for the creation and funding (or funding of previously created) irrevocable trusts. Most states' laws prohibit an AIF from creating or funding an irrevocable trust unless the POA expressly permits it.

Create IDGTs now and be ready to fund.

Leveraging ATRA - Gifts

Old Dogs and New Tricks

QPRTs

Conventional Wisdom: When term expires get an appraisal of the FMV rental value and lease the property at FMV rental rates with a written lease agreement.

Now: For MWCs, intentionally do not rent to allow estate inclusion and step-up in basis. For BCs, case-by-case analysis. For HNWCs, use conventional wisdom.

Leveraging ATRA - Gifts

ILITS

Conventional Wisdom: Include independent trustee along with traditional spousal access provisions.

Now: MWCs, Uncle Bob can be the trustee because from an estate inclusion standpoint we are not worried. For BCs, case-by-case analysis. For HNWCs, same as before.

For all clients, life insurance offers income tax benefits and creditor protection in most states.

Several recent cases have ruled that naming a RLT as the bene of a life insurance policy destroyed the creditor exemption, so an ILIT is still the safest course.

ATRA – Trust Administration

With the increased exemption amount comes simplicity for the vast majority of clients.

Before we tried to give the grantor as much control as possible while avoiding estate inclusion.

With MWCs estate inclusion is not an issue so we can simplify trust provisions. Query: Is simplification at cross-purposes with asset protection planning?

ATRA – Trust Administration

For BCs draft to permit the appointment of an independent trustee if needed in the future. Allows a wait and see approach. If not needed, trust administration stays in the family.

For HNWCs – same as before.

ATRA – Trust Administration

It’s All About the Money.

Many MWCs have set up trusts for basic estate planning as well as non-tax reasons, and they will be swept into the higher tax regime.

Trusts, even relatively small ones, will be hit with the 23.8% capital gains rate (the 20% rate plus the 3.8% Obamacare tax), even if the beneficiary herself would be subject to only a 5% capital gains rate.

Consider instead of selling stock in the trust, distributing it and selling it at the beneficiary level.

ATRA – Trust Administration

The 65 Day Window – More Important Than Ever

Make distributions during the 65 day window to lock in the 2012 individual tax rates, saving 4.6%, or more because the healthcare tax does not apply in 2012.

Draft for flexibility:

Planning for 2014 - Conclusion

ATRA will change the face of estate planning forever.

Fewer clients will (or should) be concerned about federal estate tax.

State estate taxes may be optional.

Bypass trusts may no longer be optimal.

Expanded asset protection planning opportunities.

Simplified trust administration for most clients.

Life insurance will serve new and different purposes.

Wealthy clients should view ATRA as a grace period and jump on it.

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Tax & Estate Planning Under The American Taxpayer Relief Act of 2012

Strafford

January 28, 2014

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- Bruce Steiner has over 35 years of experience in the areas of taxation, estate planning, business succession planning and estate and trust administration.

- He is a frequent lecturer at continuing education programs for bar associations, CPAs and other professionals. He is a commentator for Leimberg Information Services, Inc., is a member of the editorial advisory board of *Trusts & Estates*, is a technical advisor for *Ed Slott's IRA Advisor*, and has written numerous articles for *Estate Planning*, *BNA Tax Management's Estates, Gifts & Trusts Journal*, *Trusts & Estates*, *Journal of Taxation*, *Probate & Property*, *TAXES*, *CPA Journal*, *CLU Journal* and other professional journals.

- Bruce has been quoted in various publications including *Forbes*, *The New York Times*, *Wall Street Journal*, *Daily Tax Report*, *Lawyers Weekly*, *Bloomberg's Wealth Manager*, *Financial Planning*, *Kiplinger's Retirement Report*, *Newsday*, *New York Post*, *Naples Daily News*, *Individual Investor*, *Fox Business*, *TheStreet.com*, and *Dow Jones (formerly CBS) Market Watch*.

- Bruce has served on the professional advisory boards of several major charitable organizations and was named a New York Super Lawyer in 2010, 2011, 2012 and 2013.

Exempt amounts

- Federal estate, gift and GST tax: $5.34 million (indexed)
- New York estate tax: $1 million
  - Governor Cuomo has proposed increasing the NY exempt amount
- New Jersey estate tax: $675,000
- Connecticut estate and gift tax: $2 million

Estate, gift and GST tax rates

- The Federal estate, gift and GST tax rate is 40%
- The repeal of the state death tax credit is permanent.
- State estate and inheritance taxes are deductible against the Federal estate tax
- The New York and New Jersey estate tax is equal to the old state death tax credit, with a top rate of 16%
  - Governor Cuomo has proposed reducing the New York tax rates
- The top Connecticut estate and gift tax rate is 12%

Portability

- Portability has been made permanent for Federal estate and gift tax purposes
- However, there is no portability for state estate tax purposes, or for the GST tax
- Exception: Hawaii allows portability

Higher income tax rates

- 39.6% on ordinary income above $406,750 (single) or $457,600 (joint)
- 20% on qualified dividends and capital gains over $406,750 (single) or $457,600 (joint)
- 3.8% Medicare tax on net investment income over $200,000 (single) or $250,000 (joint)
- Estates and trusts reach the top rate (including the 3.8% Medicare tax) at $12,150 of taxable income

Planning for larger estates

- Issues
  - Portability is not indexed for inflation
  - There is no portability for the GST exemption
  - There is no portability for state estate taxes (except in Hawaii)

Planning for larger estates

- Solution
  - Shelter the Federal exempt amount ($5.34 million in 2014)
  - Pay state estate tax of $490,455 in New York or New Jersey (less in Connecticut)
  - Allocate GST exemption to the credit shelter

Planning for larger estates

- Benefits of sheltering the Federal exempt amount
  - Shelters the growth on the $5.34 million, since portability is not indexed for inflation
  - Uses the GST exemption, since there is no portability for the GST exemption
  - Obtains asset protection for the credit shelter

Planning for smaller estates

- The Federal estate tax is not a concern
  - The exempt amount is $5.34 million, and is indexed for inflation
  - Portability
- The focus is the state estate tax
  - New York -- $1 million exempt amount (may be increased)
  - New Jersey -- $675,000 exempt amount
  - Connecticut -- $2 million exempt amount

Planning for smaller estates

- Divide the assets so each spouse has at least the state exempt amount
- Shelter the state exempt amount
  - Elect portability and leave the excess above the state exempt amount to the spouse outright or in a general power of appointment trust
  - Give up portability and leave the excess above the state exempt amount to the spouse in a QTIP trust. Make a state-only QTIP election

Planning for smaller estates

- Example: Spouse A has $2 million. Spouse B has no assets. They live in New York
  - Choice #1 – all to spouse. Spouse A leaves $2 million to spouse B. Spouse B has $2 million at death. The New York estate tax is $99,600
  - Choice #2 – spouse A leaves $1 million to spouse B and $1 million to a credit shelter trust. Spouse B has $1 million at death. No estate tax in either spouse's estate
  - Sheltering the state exempt amount in Choice #2 saves $99,600 of state estate tax

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Planning for medium size estates

- There is a tension between sheltering the entire estate (up to the Federal exempt amount) at the first death, or only sheltering the state exempt amount
  - Example: each spouse has more than $1 million but less than $5.34 million

Planning for medium size estates

- Choice #1 – shelter the state exempt amount ($1 million in New York, $675,000 in New Jersey, $2 million in Connecticut) and leave the balance to the spouse, or to a marital trust. Elect portability
  - No state estate tax at the first death
  - In New York or New Jersey, a Federal QTIP election or nonelection is binding for state estate tax. However, if there is no Federal return, you can make a state-only QTIP election
  - To get both portability and the marital deduction for state estate tax purposes in New York or New Jersey, the marital share may have to be either outright or in a general power of appointment trust

Planning for medium size estates

- Choice #1 – shelter the state exempt amount
- In a general power of appointment trust, the spouse must be able to exercise the general power in favor of his/her estate. Creditors is not sufficient. Section 2056(b)(5)

Planning for medium size estates

- Choice #1 – shelter the state exempt amount
  - Filing a Federal estate tax return to elect portability is considered a Federal QTIP election or nonelection. TSB-M-11(9)M (N.Y. State Dept. of Taxation and Finance, July 29, 2011); Letter dated January 31, 2011, from Fred M. Wagner, III, Assistant Chief, Individual Tax Audit Branch, New Jersey Division of Taxation, to Robert D. Borteck, reprinted in Practical Drafting at 10462 (April 2011)
  - Revenue Procedure 2001-38
    - Is a wholly unnecessary QTIP election void or voidable?
    - PLR 201131011 – it didn't matter that the QTIP election was geared to the state estate tax

Planning for medium size estates

- QTIP in Connecticut
  - A Federal QTIP election is binding for Connecticut estate tax purposes
  - If no Federal QTIP election is made, a state-only QTIP election can be made
  - This allows for a 3-part estate plan:
    - A credit shelter for the $2 million Connecticut exempt amount
    - A gap trust for the difference between the Federal exempt amount ($5.34 million in 2014) and the Connecticut exempt amount.
      - Make a state-only QTIP election for the gap trust
      - Caution: if there is a risk of Federal estate tax in the surviving spouse's estate, note that the income from the gap trust will be included in the surviving spouse's estate for Federal estate tax purposes
    - The excess above the Federal exempt amount to the spouse outright or in a general power of appointment trust

Planning for medium size estates

- Choice #2 – shelter the first spouse's entire estate
  - Pay state estate tax
    - $35,169 in New Jersey to shelter $1 million
    - $68,803 in New York or New Jersey to shelter $1.5 million
    - $107,391 in New York or New Jersey to shelter $2 million
    - $254,911 in New York or New Jersey to shelter $3.5 million
  - Takes advantage of the GST exemption
  - Maximizes asset protection
  - May waste state estate tax if the spouse moves to another state, or if the state repeals its estate tax or increases its exempt amount

Planning for medium size estates

- Solution 2
  - Shelter the state exempt amount
  - Alternatively, give up portability and make a state-only QTIP election in New York or New Jersey

Tension between income tax and estate tax/asset protection

- Reasons to distribute income
  - Saves income tax if beneficiaries are in lower income tax brackets
  - Allows for a basis step-up at the surviving spouse's death
- Reasons to retain income in the trust
  - Keeps the assets out of the beneficiary's estate
  - Protects against the beneficiary's creditors and spouses

Roth Conversions

- Benefits of the Roth conversion
  - By paying the tax on the conversion out of other assets, you are effectively making an additional contribution equal to the tax
  - No required distributions at age 70 ½
  - Increased creditor protection
  - Section 691(c) deduction for estate taxes covers the Federal, but not the state, estate tax

Roth Conversions

- Benefits of providing for children in trust rather than outright
  - Keeps the inheritance out of the child's estate for estate tax purposes
  - Protects against creditors and spouses

Roth Conversions

- The Roth conversion is more attractive under ATRA
  - The tradeoff for leaving retirement benefits in trust is that trusts are generally subject to income tax at higher rates
  - The 39.6% bracket begins at $12,150 of taxable income for trusts, but not until $406,750 (single) or $457,600 (joint) for individuals
  - Trustees can avoid paying income tax at the trust rates by making distributions
  - However, amounts distributed will be included in the beneficiary's estate, and will be subject to the beneficiary's creditors and spouses

Roth Conversions

- The Roth conversion is more attractive under ATRA
  - Many IRA owners can convert at a tax rate less than 39.6%
  - Since Roth IRA distributions are not taxable, if an IRA owner leaves a Roth IRA in trust, there is no tension between the income tax benefits of making distributions and the estate tax and asset protection benefits of keeping the assets in the trust
  - The trustees can retain the distributions from the Roth IRA in the trust without incurring additional income tax.