Historically High Estate Tax Exemption Shifts Attention Toward Income Taxes

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Over the past year, much has been written about the American Taxpayer Relief Act of 2012 (ATRA)—passed by Congress in the early hours of January 1, 2013—and its effects on the estate tax regime. ATRA increased the estate tax rate from 35 percent to 40 percent, and also set the applicable exclusion amount at $5,000,000. The exclusion is indexed for inflation. The Internal Revenue Service (IRS) announced in Revenue Procedure 2013-35 that the applicable exclusion amount for 2014 would be $5,340,000 per individual or $10,680,000 for a married couple.

In addition to ATRA's large exclusion amount, estate planners received a new tool in the form of portability in 2010. Portability allows the surviving spouse to claim the unused applicable exclusion amount of the deceased spouse (the "Deceased Spouse Unused Exclusion," or "DSUE"). Portability, however, does not apply to the Generation Skipping Transfer Tax exemption. The executor of the deceased spouse's estate must elect portability by filing a Form 706. Given the large applicable exclusion amount, few estates will be subject to the estate tax. The most recent statistical data released by the IRS showed that just under 3,800 taxable estate tax returns were filed in 2012 (for 2012 the applicable exclusion amount was $5,120,000 per person).

Estate planners today, however, are giving greater attention to the income tax consequences of existing estate plans given the higher income tax rates and the historically high applicable exclusion amount. For many clients not subject to the estate tax, the step-up in basis provided by the Internal Revenue Code will likely be of greater value than in years past. Even as estate planners devote more attention to income taxes, there remain other non-tax reasons that may override income tax concerns.

Diminishing Impact of Estate Taxes, Renewed Focus on Income Taxes

While much of our focus has been dedicated to the estate tax, and how to avoid or reduce it, fewer estates will become taxable estates as a result of ATRA's large applicable exclusion amount. A staple of modern estate planning has been the bypass trust commonly used to prevent the wasting of the first-to-die spouse's applicable exclusion amount. By funding the credit shelter trust with assets valued up to the applicable exclusion amount, the surviving spouse may save his or her own exemption to shield the assets remaining in that estate.

One negative consequence of excluding the assets from the surviving spouse's estate is the lack of a step-up in basis of the assets held in the credit shelter trust which is provided by Section 1014 of the Internal Revenue Code. Without portability, a couple with an estate valued at over $5,340,000, but less than $10,680,000 would need to utilize a bypass in order to avoid paying estate taxes upon the death of the second spouse. Portability may help solve this problem, assuming the executor takes the necessary steps to elect portability.

Prior to the Bush-era-tax-cuts—when the applicable exclusion amount was low and the estate tax rate was high—the sting of the estate tax was worse than the capital gains tax on appreciated capital assets. Because ATRA imposes a 20 percent tax on capital gains and the Affordable Care Act imposes a 3.8 percent tax on net investment income above certain thresholds, the step-up in basis becomes much more valuable provided the estate is not subject to the estate tax. For trusts, ATRA and ACA currently impose the combined 23.8 percent tax on the excess of the capital gains exceeding adjusted gross income of $11,950, which is also indexed for inflation.

Through the use of joint trusts and general powers of appointment, estate planners are considering various ways upon which all of the assets of the marital unit will receive a step-up in basis after the death of the first spouse—a benefit which is particularly useful in non-community property states. And while not trying to get greedy, what about a second step-up in basis upon the surviving spouse's death? The simplest method of obtaining a step-up in basis upon the death of the surviving spouse requires no trust at all by simply making an outright bequest to the surviving spouse. Upon the surviving spouse's death, all of the assets would receive a step-up in basis.

There are risks to an outright bequest, and that risk increases proportionally with respect to how dysfunctional the family. So long as the surviving spouse has control over the disposition of the deceased spouse's assets, there remains the possibility that the ultimate disposition will not be in accordance with the deceased spouse's intent. However, it is worth considering the tax savings of reducing the accumulated gains that may occur between the death of the first spouse and the death of the surviving spouse. Outright dispositions are not the only method that results in estate inclusion, but every method does result in significant control by the surviving spouse over the assets of the deceased spouse.

Non-Tax Reasons May Trump Income Tax Savings

For those clients that are more concerned with the misuse of their assets after their death, income tax savings will be secondary. While tax considerations have often been the driving force for estate planning, there have long been other factors leading clients to place assets in trust regardless of the negative tax consequences. Grantors may be concerned with both their future creditors and the creditors of their surviving spouse or children. No one is exempt from an untimely death, and few individuals would be comfortable leaving a substantial estate to a minor child. Clients also have concerns that their estate may be diverted from their natural heirs in the event of a remarriage by the surviving spouse. While there may now be an incentive to review alternatives to traditional bypass trusts given the large estate exemption, we must still be cognizant of the non-tax justifications for traditional estate planning tools.

Asset protection, especially for individuals in high risk professions, may trump income tax savings for heirs. As states compete for trust business, legislatures are providing greater protections against potential creditors. Domestic asset protection trusts are becoming increasingly common. States such as Alaska, Nevada, South Dakota and Ohio have enacted statutes that provide significant protections against potential creditors. Domestic asset protection trusts enable the grantor to shield assets from future creditors by transferring the assets into an irrevocable trust with a third party, independent trustee. The grantor may be a beneficiary, but the trustee has full discretion regarding distributions. Both the drafting attorney and the grantor must be careful to avoid fraudulent transfer statutes which generally protect known or likely creditors. Asset protection trusts have the added benefit of removing the assets from the grantor's estate, but also the previously discussed disadvantage of no step-up in basis at the grantor's death.

Another concern that may trump any tax savings is remarriage of the surviving spouse, and the use of the deceased spouse's assets by unwanted individuals. Many clients prefer certainty in how their assets will be distributed and who may enjoy their benefit. By leaving assets outright to the surviving spouse, or granting the surviving spouse the right to appoint the assets held in trust, the first-to-die spouse is at the mercy of the surviving spouse as to who may ultimately receive the benefit of the deceased spouse's assets.

While ATRA provided a "permanent" extension of the inflation-indexed $5,000,000 applicable exclusion amount and simplified some aspects of estate planning, estate planning attorneys and clients still have numerous factors to consider before deciding on the proper course of action. While alternatives to the traditional bypass trust can provide significant income tax savings, non-tax reasons may still exist that support the use of such trusts even if the primary goal is no longer the reduction or elimination of the estate tax. As always, the individual goals and objectives of the client will drive the estate planning process; however, as a result of the large applicable exclusion amount and higher taxes on capital gains, exploring the income tax consequences of any proposed plan has taken on greater importance.

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