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Early Twenty-First Century Estate Planners Shift Focus from Estate to Income Tax Planning

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This article will focus on successive changes to the federal tax code since the beginning of the 21st century—which have resulted in a dramatic paradigm shift in estate planning—as well as some of the planning strategies that have garnered increased attention as a result of those changes.

Recent Changes to the Estate Tax System

A. Changes to the Federal Estate Tax

Throughout most of the 20th century, estate planners focused the greater part of their energy on reducing the impact of transfer taxes on their clients. Now, halfway through the second decade of the 21st century, most well-heeled estate planners increasingly focus their energy on devising income tax savings strategies for those same clients.

This should not come as a surprise: As illustrated in Table 1 below, the steady rise in the estate tax exemption since 2001 has resulted in a corresponding decline in the number of taxpayers subject to the tax.

Table 1

Estate & Gift Tax Exclusions & Rates 2000-2016

Year	Exclusion from Estate Tax	Exclusion from Gift Tax	Estate & Tax Rates
2000-2001	$675,000	$675,000	55%
2002	$1,000,000	$1,000,000	50%
2003	$1,000,000	$1,000,000	49%
2004	$1,500,000	$1,000,000	48%
2005	$1,500,000	$1,000,000	47%
2006	$1,500,000	$1,000,000	46%
2007	$1,500,000	$1,000,000	45%
2008	$2,000,000	$1,000,000	45%
2009	$3,500,000	$1,000,000	45%
2010	Repealed/$5,000,000	$1,000,000	35%
2011	$5,000,000	$5,000,000	35%
2012	$5,120,000	$5,120,000	35%
2013	$5,250,000	$5,250,000	40%
2014	$5,340,000	$5,340,000	40%
2015	$5,430,000	$5,430,000	40%
2016	$5,450,000	$5,450,000	40%

According to IRS statistics, the number of filed estate tax returns decreased by 87% from 2003—when the applicable exclusion was $1,000,000 and 73,100 returns were filed—to 2012, when the applicable exclusion was $5,120,000 and only 9,400 returns were filed. In fact, according to the Wall Street Journal (http://www.wsj.com/articles/government-aims-to-limit-technique-for-lowering-estate-gift-taxes-1470155292), IRS data indicates that only about 5,200 taxable estate tax returns were filed with the IRS in 2014.

While it may be true that these steep declines and the temporary repeal of the estate tax in 2010 did not represent the long-heralded death knell for the estate tax, planners relying primarily on estate tax planning to earn a living might well be a dying breed—particularly after the permanent changes made to the IRC by the 2012 American Taxpayer Relief Act.

These changes include hefty increases of the estate, gift, and generation-skipping transfer tax exemptions—up to $5,000,000. With inflation indexing, those exemptions—as of January 2016—have climbed to $5,450,000. Other changes include a top federal estate tax rate of 40%, an increase in the top federal income tax rate to 39.6%, an increase of the top capital gains rate to 20%, and the implementation of a 3.8% Medicare Tax.

B. Changes to the New York State Estate Tax

As outlined below, New York State began to phase up its estate tax exemption up from $1 million, which also contributed to this change in focus.

-- As of Apr. 1, 2014, the New York exemption increased to $2,062,500.

-- As of Apr. 1, 2015, the New York exemption increased to $3,125,000.

-- As of Apr. 1, 2016, the New York exemption increased to $4,187,500.

-- As of Apr. 1, 2017, the New York exemption will increase to $5,250,000.

-- As of Apr. 1, 2019, it will be in sync with the federal exemption.

-- Thereafter, the New York exemption will be adjusted annually for inflation.

-- The benefits of the exemption are rapidly phased out once a taxpayer's gross estate exceeds the allowable exemption amount. The benefits are completely phased out once the gross estate exceeds 105% of the allowable exemption amount. This abrupt phase-out is referred to as the "Estate Tax Cliff."

-- New York's top marginal estate tax rate remains at 16% for now.

Because New York has no gift tax and relies on the computation of the former federal state death tax credit to determine its tax—which excludes adjusted taxable gifts from its calculation—New York has instituted a temporary three-year clawback rule to mitigate the loss in revenue from deathbed transfers. In general, when calculating New York estate tax, gifts made within 3 years of death will be brought back into the estate if they were made between Apr. 1, 2014, and Jan. 1, 2019. This is similar to the federal treatment of adjusted taxable gifts for estate tax purposes.

Planning with Appreciating Assets

A. Gifting

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("Tax Act") instituted a temporary but substantial increase to the gift tax exemption—from $1 million to $5 million. This triggered a rash of generosity among taxpayers eager to achieve estate tax savings through gifting before the exemption was scheduled to revert back at the end of 2012. This trend continued—albeit more slowly—after the American Taxpayer Relief Act of 2012 made permanent increases to the estate, gift, and generation-skipping transfer tax exemptions, with provisions for annual inflation adjustments.

The lifetime exemption from gift tax provides an opportunity to achieve substantial federal and New York estate tax savings through transfers of assets anticipated to appreciate in value. This technique of excluding appreciation from a decedent's estate is known as an "Estate Freeze".

B. Sales to Intentionally Defective Grantor Trusts

The low-interest environment (see Table 2 below) that has prevailed for the better part of the past decade makes sales to Intentionally Defective Grantor Trusts (IDGTs) an appealing estate freeze technique. The objective is the same as the gifting technique described above—to keep the appreciation of rapidly growing assets out of the grantor's estate.

Table 2

The Applicable Federal Rates (AFR) for August 2016

Short Term AFR (up to 3 YRs)	.56%

Mid Term AFR (up to 9 YRs)	1.18%
Long Term AFR (over 9 YRs)	1.4%

The outline of this estate freeze strategy can be summarized as follows:

1. Grantor sells assets—typically fractional interests in a limited liability company (LLC) or family limited partnership—to a grantor trust.

2. The assets are sold in exchange for a promissory note with an interest rate set by the appropriate (short-, mid- or long-term) applicable federal rate in effect at the time of transfer. Typically, the note provides for annual interest-only payments with a balloon payment at the end of the term.
3. The balance of the note, at the date of death, will be included in the grantor's estate.

4. The properly drafted IDGT will be excluded from the grantor's estate.

5. During the grantor's lifetime, the grantor will pay the tax on the income generated by the assets contributed to the IDGT, thus further reducing the grantor's estate and allowing the assets of the IDGT to grow tax-free.

6. As a result of the unmarketable nature of privately held companies and the lack of control typically associated with fractional interests in LLCs, steep valuation discounts commonly reduce the value of the underlying LLC assets by 30% to 40%, significantly enhancing the tax savings associated with this estate freeze technique.

C. The Grantor Retained Annuity Trust

The Grantor Retained Annuity Trust (GRAT) is another popular "Estate Freeze" technique that works well in a low-interest rate environment. The GRAT strategy can be summarized as follows:

1. Grantor contributes an appreciating asset to a GRAT.

2. Grantor retains the right to receive periodic (typically annual) annuity payments during the GRAT term.

3. The annuity payments are set by the IRC section 7520 rate in effect at the time of transfer.

4. If the GRAT performance exceeds the IRC rate, the grantor's beneficiaries come out ahead. The IRC rate for August 2016 is 1.4%.

5. The income generated by GRAT assets is taxed to the grantor so the GRAT grows, free of income tax, for the beneficiaries.

6. Grantor must survive the GRAT term in order to exclude the GRAT from his or her estate.

7. Additional tax savings may be obtained by using rolling GRATs (short-term GRATs that are repeated over and over) or zeroed-out GRATs (where the value of the gift is $0).

Beware of the Carryover Basis Trap. Take caution when employing an estate freeze strategy to make sure that adverse income tax consequences will not exceed the resulting estate tax savings. This risk is significant when highly appreciated assets are gifted because assets included in a decedent's estate at the time of death receive a step-up in basis for income tax purposes, whereas assets gifted during life have a carryover basis in the hands of the donee. Assets sold to an IDGT or a successful GRAT are also not included in the grantor's estate and, therefore, do not receive a step-up in basis for income tax purposes upon the death of the grantor.

Making Use of Portability to Achieve Estate Tax Savings. The 2010 Tax Act introduced the concept of portability on a temporary basis—which was eventually made permanent by the American Taxpayer Relief Act in 2012.

Portability of Deceased Spouse's Unused Exemption. Under prior law, the estate and gift tax exemption would be lost if it was not used by the decedent. If portability is elected, the deceased spouse's unused exemption (DSUE) is made portable (https://www.gpo.gov/fdsys/pkg/PLAW-111publ312/html/PLAW-111publ312.htm) to the surviving spouse. Portability ensures that the maximum allowable exemption from estate tax available to each spouse may be utilized even in the absence of credit shelter tax planning.

Nevertheless, it is important to examine how portability works and its limitations. Most practitioners still believe that credit shelter planning is both beneficial and prudent, notwithstanding the availability of portability. The key features and limitations of portability can be summarized as follows:

-- Spouse can utilize deceased spouse's unused exemption.

-- To utilize portability, an irrevocable election must be made on a timely filed estate tax return of the deceased spouse (see IRC section 2010(c)(5)(A)).

-- Portability will be lost if not utilized prior to remarriage (see IRC section 2010(c)(4)(B)).

-- The statute of limitations for the IRS to audit the deceased spouse's return is extended (see IRC section 2010(c)(5)(B)).

-- The deceased spouse's unused exemption is not indexed for inflation (IRC section 2010(c)(4)(B)).

-- The generation-skipping transfer tax exemptions are not portable.

Planning to Achieve the Maximum Step-Up in Basis at the Time of Death

According to IRC section 1014, the beneficiaries of a decedent's estate are entitled to a step-up in basis to fair market value as of a decedent's date of death. With the increase in the top federal capital gains tax rate from 15% to 20%, planners and taxpayers are paying increased attention to maximizing basis whenever possible.

A. Credit Shelter Trust Planning

One estate tax planning technique frequently utilized by married couples is splitting the assets of the first spouse to die into two trusts: a credit shelter trust, to which the exemption is applied, and a marital trust, to which the assets in excess of the exemption amount are typically distributed. The assets passing to the exempt trust will receive a step-up in basis at the time of the first death and will be excluded from the second spouse's estate. They will not, however, receive a step-up in basis upon the death of the second spouse unless action is taken in the interim to include the assets of the otherwise exempt trust in the surviving spouse's estate. The assets passing to a properly drafted marital trust will qualify for the marital deduction for estate tax purposes under IRC section 2056, effectively deferring the estate tax on those assets until they are included in the second spouse's estate under IRC section 2044. Unlike the credit shelter trust, the assets of the marital trust will qualify for step-up in basis upon the death of the surviving spouse.

Given these facts, most married couples with large estates want to know how they can maximize the benefits of both their exemptions from estate tax while also obtaining a second step-up in basis upon the death of the surviving spouse. Some possible solutions to this conundrum include the following:

-- Make use of postmortem tax planning upon the death of the first spouse rather than relying on a formula approach to determine the amount of the exemption to be applied to the credit shelter trust. For example, use disclaimer provisions to allow the surviving spouse to determine the amount with which to fund the credit shelter trust, or use the contingent QTIP (marital trust) provisions to allow a non-spouse executor to determine the optimal funding amount for the credit shelter trust and marital trusts.

-- Make use of the surviving spouse's portability election to enhance his or her available estate tax exemption and minimize the amount passing to the credit shelter trust. The assets passing to the marital trust or directly to the surviving spouse will be included in that spouse's estate at the time of death and qualify for the step-up in basis.

-- Give the trustee of the credit shelter trust the power to grant the surviving spouse a general power of appointment, causing inclusion in the surviving spouse's estate under IRC section 2041 and achieving a step-up in basis. The greatest benefit of this technique is that the trustee can employ it at any time right up until the time of the surviving spouse's death.

B. Techniques to Enhance Tax Basis for Multi-Generation Grantor Trusts

Grantor style dynasty trusts can produce enormous savings in estate and generation-skipping transfer taxes for multiple generations. There is, however, generally no step-up in basis for these trusts upon the death of the grantor because by their very nature they are designed for exclusion from the taxable estate.

When assets are liquidated years or decades after trust funding, the beneficiaries might well recognize substantial capital gains. Techniques to avoid some or all of these potential gains include the following:

-- During the grantor's lifetime, he or she may periodically exercise the grantor's reserved power to substitute (a common grantor trust power). In fact, the grantor might wish to consider employing this technique on a quarterly basis, substituting high-basis assets in his or her own name—such as cash—for low-basis assets held by the trust.

-- If the power to substitute is unavailable, have the grantor purchase assets from the trust even if he or she has to borrow to do so. There is no tax impact on transactions between a grantor and a grantor trust.

C. Additional Options for the Estates of Grantors No Longer Subject to the Estate Tax

-- If the trust protector has the power to do so, have him or her grant a general power of appointment to an elderly or terminally ill trust beneficiary over trust assets for which a step-up in basis is desired.

-- Grant the grantor's executor a "put power" over any retained interest in an LLC to which valuation discounts would otherwise apply. This will eliminate any valuation discounts not already regulated out of existence by the IRS, resulting in a substantial increase in basis.

-- Change the state and governing law of a self-settled trust to a venue that does not allow them, causing estate tax inclusion.

If none of these options are available, consider utilizing New York's new and improved (http://law.justia.com/codes/new-york/2014/ept/article-10/part-6/10-6.6) decanting statute to decant to a trust that does.

Planning During Times of Changing Law

Estate planners can only plan with current law; however, it is important to keep in mind certain planning techniques that the Obama administration has attempted to eliminate. For example, for high net-worth clients considering a dynasty trust, it is probably best to begin that planning now—Obama's 2017 budget once again includes a provision to limit dynasty trusts to a 90-year period. The 2017 budget would also limit the GRAT term to a maximum of ten years and require a minimum remainder at the end of the GRAT term to make it impossible to create a zeroed-out GRAT. The budget also proposes returning to 2009 exemption levels of $3,500,000 for the estate and generation-skipping transfer tax and $1,000,000 for gift tax purposes, while increasing the top marginal estate, gift, and generation-skipping transfer tax rate to 45%.

Democratic presidential nominee Hillary Clinton has also proposed returning to 2009 exemption levels, while her Republican rival Donald Trump would eliminate the estate tax entirely. Finally, the IRS has proposed regulations that would eliminate valuation discounts for family-owned businesses. Clients that would benefit from the leverage provided by this technique should begin planning now.

No one can really be sure what the field of estate planning will look like in the future. Consequently, the static formula approach of the past should be discarded in favor of the more flexible approach of the new millennium—which allows the estate plan to evolve as rapidly as the law changes.

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