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Elder, Estate Planning & Probate Law: Is a New Tax Tail Wagging the Estate Planning Dog?

By: **Anu Mullikin and Michelle Arruda**

The tax landscape has changed as a result of three recent federal tax developments. First, there has been an increase in the income tax and capital gains tax rates, with top earners being subject to taxes of 39.6 percent and 20 percent, respectively. Second, there is a new 3.8 percent tax on “net investment income,” known as the “Medicare surtax.” With the addition of the surtax, taxpayers could pay tax at rates of as much as 43.4 percent and 23.8 percent, respectively. State income taxes add to that burden.

And, federal transfer tax rates and exemptions have changed dramatically. As recently as 2008, the exemption from the federal estate tax and from the federal generation-skipping transfer (GST) tax was only $2 million, the exemption from the federal gift tax was $1 million, and the top federal transfer tax rate was 45 percent.

Under the American Taxpayer Relief Act of 2012 (ATRA), which made “permanent” changes to the federal transfer tax system, the exemptions are now $5 million, indexed for inflation, and the top tax rate is 40 percent. Moreover, ATRA made permanent estate tax “portability” – the ability of a surviving spouse to “inherit” her predeceased spouse’s unused gift and estate tax exemption (but not GST exemption).

As a result of these changes, the gap between the top effective income tax rates and transfer tax rates has been reduced. In fact, for residents of some states, the highest effective combined federal and state income tax rate may be greater than the highest combined transfer tax rate.

This, in turn, has resulted in a deluge of estate planning articles and presentations with a single-minded focus on income tax planning in the estate planning context. Under the new regime, income tax basis step-up on death is key, purportedly flipping traditional tax planning in the estate planning context on its head.

Under the new regime, there are some key pieces of advice, particularly for estates under the current estate tax exemption ($5.34 million for an individual and $10.68 million for a married couple in 2014). First, don’t make gifts using your gift tax exemption. Gifted assets get carryover basis, whereas inherited assets generally get a stepped-up basis. When the recipient sells the gifted asset, the net value to the recipient after capital gains taxes on the gifted asset and its appreciation may be less than the net value the recipient would receive after the transferor’s death, even if those assets are subject to estate tax.

Secondly, don’t use credit shelter trusts for married couples. Instead, rely on portability to utilize both spouses’ combined exemptions and get a step-up in basis on all of the assets that are included in the surviving spouse’s estate, including the appreciation that occurred after the first spouse’s death. With a credit shelter trust, when the ultimate recipient of the sheltered assets at the second death sells those assets, the net value after capital gains taxes may be less than the net value to the recipient after the estate taxes incurred at the surviving spouse’s death.

Third, look for ways to cause estate tax inclusion of as many assets as possible, as often as possible. This means using strategies such as a Joint Exempt Step-Up Trust (JEST), in which spouses form a joint revocable trust that either spouse can revoke until the death of the first spouse to die. The first spouse to die has a general power of appointment over all of the assets. Or, consider a lifetime QTIP trust where the gifted assets are transferred back to the grantor outright upon the spouse’s death; or a gift from the child’s generation up to the parent’s generation, to get a basis step-up at the parent’s death.

Finally, don’t use discounting techniques. For example, do not sever spousal joint tenancies. With a joint tenancy, there is a step-up in basis equal to 50 percent of the value of the joint asset upon the death of the first spouse to die, as opposed to one that is equal to the discounted value of a 50 percent undivided interest as a tenant in common.

To be sure, this advice makes good sense. But didn't we always consider income tax issues? Good estate planning always has meant that, considering the tax issues only, a gift or credit shelter trust was advisable only if the potential estate tax savings outweighed the potential income tax costs. And the above techniques for obtaining a step-up in basis always have been available, if the potential income tax benefits did not result in increased federal transfer tax costs.

Estate planning also always took into consideration the tax brackets of trusts versus the tax brackets of the individual beneficiaries. It is and always has been about "running the numbers" and, in doing so, making reasonable assumptions about appreciation and tax rates, tempered by an awareness that tax law is never permanent.

All that really has happened is that, with higher transfer tax exemptions and the availability of portability, the need for estate tax planning has decreased and the opportunity to obtain a step-up in basis for a greater amount of assets, and to shift income out of the less favorable trust income tax brackets without incurring federal transfer tax, has increased.

In the end, good planning always involves both the income and estate tax issues. More importantly, however, good estate planning should mean achieving the client's non-tax objectives in a manner that minimizes the overall tax burden for the client and the objects of her affection. It would be a shame if a new tax tail begins to wag the estate planning dog.

Anu Mullikin is a shareholder at Devine Millimet and chairs the firm's trust and estates practice group.

Michelle Arruda is a shareholder and a member of the firm's trusts and estates practice group.

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New Hampshire Bar Association
2 Pillsbury Street, Suite 300, Concord NH 03301
phone: (603) 224-6942 fax: (603) 224-2910
email: NHBAinfo@nhbar.org