Southern Arizona Estate Planning Council

Planning for the 99% - Planning for Estates Under $5 Million

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I. Federal Transfer Taxes Have Become Irrelevant for Most Americans

A. In 2015, the applicable exclusion from the federal gift and estate tax is $5,430,000. This number is indexed annually for inflation. The applicable exclusion from the generation-skipping transfer tax (GST) is $5,430,000. Clients whose estates fall under these thresholds will be referred to as persons of "moderate wealth" for purposes of this discussion.

B. These exclusions became "permanent" as the result of the American Taxpayer Relief Act of 2012 (ATRA). ATRA provides an applicable exclusion amount for estates and gifts of $5 million, indexed for inflation. Code Section 2010(c).

C. ATRA also made permanent the concept of "portability" which allows the unused federal estate tax exclusion of a deceased spouse (the "DSUE") who died after 2010 to be used by the surviving spouse. Depending on the estate plan of the first deceased spouse, portability can give the surviving spouse an available applicable exclusion for lifetime gifting and use at death of over $10 million. (In 2015, as much as $10,860,000). (Note that the GST exclusion is not portable).

D. In 2001, 120,000 federal estate tax returns were filed, of which 60,000 were for taxable estates. In 2010, 15,000 returns were filed. In 2012, less than 4,000 taxable estate tax returns were filed. Estimates are that less than 0.2% of Americans – fewer than 2 out of every 1,000 people who die - will be subject to the federal estate tax with the current exclusion structure in place. The Tax Policy Center suggests that only 3,800 estates in the United States (1 in every 700 people who die) will pay any estate tax in 2015.

II. The "New Normal" in Estate Planning – Simplicity and Client Resistance?

A. If clients no longer fear the imposition of costly transfer taxes and the complex planning needed to avoid such taxes, will clients be willing to embrace complex planning and the professional fees often associated with such complexity?

B. The client may want to opt for the most simple (and least expensive) of plans which may make complete sense when viewed solely as a tax planning decision, but which may be a serious mistake when other planning considerations are raised. The challenge for the planner will be to convince

the client that “simple” from the tax standpoint does not always translate to “simple” or even “correct” from a wide range of other perspectives.

C. It is certainly likely that many persons will take a “do it yourself” approach to planning. With will, trust and other forms readily available on the internet and in stationary stores and the knowledge of the absence of federal tax liability, many persons will decide to save the cost of professional planning fees with an attitude suggesting there are no “penalties” for failure, since no tax will be owed no matter what they sign and do – or do not do. It is suggested that this can be a huge mistake for some families, which, like many mistakes, will only be learned the “hard way”.

III. A New Emphasis in Planning

A. Refocused Planning.

The major focus for estate planning for married couples having assets under $5.43 million will turn to core dispositive planning, income tax planning (such as achieving basis step up at death), and the preservation and management of assets.

B. Core Dispositive Planning

1. Planning should begin with a review of the clients’ current personal and financial situation and an examination of the current estate plan and all associated documents.

    a. Who are the desired beneficiaries to whom assets should be given or bequeathed?

    b. Coordination of beneficiary designations is still required to achieve the desired result.

    c. There should be a review of the client’s existing estate planning documents from a new perspective.

        i. Do formula clauses that made sense in a different tax environment still work? Careful if the client’s documents still include formulas referring to the “maximum amount that can pass without tax consequences” to children and balance to spouse. Will there be any balance? Careful of formulas leaving the surviving spouse only enough assets to “reduce to zero” the federal estate tax. The applicable exclusion may get to zero long before a marital gift is needed.

ii. Are they (formulas) still needed if the client lives or does not live in a “decoupled state” (i.e. a state that still has an independent death tax with exclusions well below the federal level of tax exclusions)?

iii. Is there still a need for a credit shelter trust that no longer will generate federal estate tax savings?

d. What gifts has the client made? If they were made to trusts, how are the trusts structured and how are they operating? Are the trustees currently in place or named as likely successors the right choices? If there has been a pattern of gifting to family members that was motivated by transfer tax concerns that no longer apply, what are the expectations of those family members? A discussion may be needed.

e. Look at beneficiary designations of items that pass outside of a will (life insurance policies, retirement plans). If trusts designed to achieve transfer tax savings are designated beneficiaries, perhaps they are no longer desired or necessary.

2. A real concern for the planner in this situation is the motivation of the client. In the pre-ATRA world, taxes were a primary motivating factor. “I will plan your estate and save you taxes” was an acceptable way to overcome the client’s reluctance to address planning. Now, estate tax savings has been largely or completely removed from that picture. The challenge for the planner is to get the client to focus on the non-tax aspects of planning which remain of primary importance.

C. <u>**Checklist of Areas Where Estate Planning is Still Required**</u>

1. Planning for the disposition of the client’s assets at his or her death.

2. Asset protection planning. (Protection from creditors and predators)

3. Planning for disability and incompetency.

4. Business succession planning (with or without concerns that the estate tax will force a succession plan to be implemented)

5. Planning for possible divorce and other family relationship dissolutions.

6. Charitable giving (for its own sake, not for death tax savings, and because income tax considerations will still be relevant. Techniques,

such as lifetime charitable remainder trusts, would not be adversely affected at all).

7. Life insurance planning (other than to provide funds to pay death taxes).

8. Fiduciary litigation (may become a greater problem because there is more to fight over as an inheritance with the government out of the picture).

9. Retirement planning.

10. Planning to pay state death taxes (in those states that have decoupled from the federal system and have their own death tax).

11. Planning to avoid or minimize gift taxes (if the client desires to give away more than the indexed applicable exclusion amount for gift tax purposes).

12. Planning for children with disabilities and special needs.

13. Planning for spendthrift children.(Incentive and Disincentive Trusts)

14. Planning for clients owning real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to possible state estate taxes).

15. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.

16. Planning for nonresident aliens with assets in the U.S. or who plan to move to the United States.

17. Planning for the possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.

    a. The Obama Administration Budget Proposal for 2016 suggests a return to the 2009 rules, i.e. an estate tax exclusion of 3,500,000, a GST exclusion of $3,500,000, a lifetime gift exclusion of $1,000,000 – all with no inflation adjustments – and an increase in the tax rate from the current 40% to 45%.

    b. This may pose a dilemma for some planners and their client – do I make substantial gifts now, while the exclusion is at the current level, and move a lower income tax basis to the donees, or do I hold on to property, refrain from aggressive lifetime gifting with

the expectation of a higher basis to heirs at death, only to discover property will be taxed that would have avoided tax if transferred earlier?

18. Planning to pay education expenses, including contributing to Code Section 529 plans.

19. Identifying guardians for minor children, if and when needed.

20. Considerations arising with respect to eldercare planning.

    a. Making certain that appropriate durable powers of attorney and health care directives are in place. (This is a planning consideration not only for elderly clients, but appropriately for all clients).

        i. Consider more specific directives with respect to gifting to protect against possible “elder abuse”.

        ii. Warn the power holder about not giving away assets that have substantially appreciated so that those assets will receive a basis step-up at death.

        iii. Consider some directions about accessing digital assets in the event of incapacity.

    b. With the demographic shift in the population and the aging of the baby boom generation, eldercare planning will take on a much greater significance. Planners should expect questions about when social security benefits should commence or be deferred and managing appropriate social security benefit strategies such as file and suspend, and accept and repay.

    c. Long-term care insurance will be an eldercare concern of many clients, as will Medicare benefits and Medicaid eligibility.

IV. Portability Must Be Addressed By Every Married Person

A. Why Portability?

The primary motive for enacting portability of the federal estate tax exemption was simplifying estate planning for married couples. However, what often appears as simple may have a number of serious decisions associated with it.

1. An issue all clients will face at all levels of wealth is whether to make the portability election at the death of the first spouse. Filing a federal

estate tax return (Form 706) and making the election will be preferable in most cases. Code Section 2010 (c)(5). The assets of the decedent must be valued in any event for income tax basis purposes. The portability regulations allow a relaxed reporting procedure for filing the required federal estate tax return (Form 706) to merely list assets and their estimated approximate values rather than listing and supporting (with appraisals, etc.) the values of each of the assets. Completing Form 706 will not be overly onerous and should not be especially expensive for the client. If an estate tax return is not filed to make the portability election, the planner will want to obtain a waiver letter signed by the executor (and perhaps the beneficiaries).

2. If a federal estate tax return is required to be prepared in a decoupled state in connection with the filing of the state estate tax return, the incremental cost of filing the federal return will be even less onerous.

3. ATRA made portability permanent, and there have been no legislative proposals to reverse that determination.

4. The law allows portability of any unused applicable exclusion amount for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to as the "DSUE" amount, i.e. the "Deceased Spouse's Unused Exclusion". The surviving spouse can use the DSUE amount either for lifetime gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse." Reg. 20.2010-3(a)(3).

   a. **Example 1**: A and B are married. A dies. Form 706 is filed at A's death. B gets the DSUE as A's surviving spouse. Now B remarries C. B can still use the DSUE from A for gifting and/or at death, as well as B's own applicable exclusion. B and C can also utilize C's applicable exclusion as well.

   b. **Example 2**: Assume in the above Example C dies while B is still living. Now, C is B's last deceased spouse. Any remaining unused DSUE that B obtained from A is now lost, since A is no longer B's last deceased spouse. If Form 706 is filed for C's estate, B may now obtain DSUE from C if any is available. If C has no DSUE (perhaps C left the exclusion amount to children of a prior marriage) B has no DSUE available, and is "limited" to B's own applicable exclusion. Reg. 20.2010-3(a)(3).

c. There is a "use it or risk losing it" point to be made here. Gifts made by a surviving spouse will first use the DSUE amount from the last deceased spouse before using the surviving spouse's own basic exclusion amount. Reg. 25.2505-3(b). If there is a subsequent marriage, the DSUE from the first deceased spouse remains available so long as the most recent spouse remains alive. If the second spouse dies, the unused DSUE of the first spouse is lost.

5. It is suggested that every estate of a deceased married person should make a portability election. Even if the family assets are significantly below the federal estate tax filing threshold, it is possible that a "windfall" through good fortune or inheritance could occur in the future to increase a survivor's estate. The survivor could remarry a significantly wealthier person making the DSUE of the deceased spouse a valuable asset. The survivor could sustain an injury leading to an unanticipated but significant financial recovery.

6. The IRS had announced that a "late" Form 706 may be filed to make the portability election for persons who died after December 31, 2010, so long as the Form was filed by December 31, 2014. Rev. Proc. 2014-18. Despite requests by practitioners, the final Regulations issued by the IRS on June 12, 2015 (TD 9725) did not provide any further general extension to make a late portability election, rather leaving it to the discretion of the IRS.

B. "Simple" Wills Are More Likely to be Favored Now – Is That the Right Call?

1. With the portability provisions having been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, (the "I Love You" Will) relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. Is that the correct decision? The "lure" of simplicity through portability and reduced planning costs may in some cases make the planning process more complicated to communicate fully to clients the advantages and disadvantages of planning alternatives. The advantages of simplicity and a stepped-up income tax basis at the surviving spouse's death may be a hard combination of perceived advantages to overcome.

2. Why Still Use a Bypass Trust at the First Spouse's Death in a Portable World?

a. The DSUE amount is not indexed for inflation. Is there concern about long-term appreciation between the first and second deaths? The bypass trust protects the surviving spouse's estate from being

taxed on appreciation between the first and second death. But, if there has been appreciation that still leaves the survivor short of the federal estate tax threshold, consider using a trust and giving an independent person, such as the trustee or a trust protector, the right to grant the surviving spouse a general power of appointment over the assets in the bypass trust to force their inclusion in the spouse's estate, thereby gaining a basis increase with no estate tax liability.

b. Growth in the assets in a bypass trust is excluded from the estate of the survivor. Growth is not excluded from the gross estate of the surviving spouse where assets are received outright.

c. There is no portability of the GST exclusion. A bypass trust at the first death passing ultimately to skip persons can secure the benefits of the first decedent's GST exclusion

d. There is an unlimited statute of limitations on values for purposes of determining the DSUE that begins to run from the time the first deceased spouse's estate tax return is filed. The statute of limitations does run on values if a bypass trust is funded at the first spouse's death. Record-keeping must be maintained until the second spouse dies and that spouse's estate tax issues are resolved. The unlimited statute of limitations applies only to the "proper" calculation of the decedent's DSUE amount. The federal estate tax liability of the decedent's estate cannot be reopened once the "standard" statutory three-year statute of limitations has run.

e. The DSUE of the first spouse is lost if the surviving spouse remarries and the new spouse predeceases the surviving spouse and leaves behind little or no unused exclusion. The surviving spouse can use the decedent's DSUE for lifetime gifting, and the "ordering rules" provide that the DSUE is used by the survivor before the survivor's own exclusion.

f. The state exemption amount is not portable (except, to date, in Hawaii which has made its state estate tax exclusion portable). In a decoupled state, the client may as a minimum want to fund a bypass trust with the amount of the state exclusion.

g. A bypass could be funded with discounted hard to value assets when there may be a low audit risk at the first spouse's death where there is no federal tax liability.

h. The use of a bypass trust can avoid unequal treatment that might otherwise occur in a blended family situation (where at least one

spouse has children by a prior marriage). The presence of a blended family situation may be one of the more compelling reasons to advise a client to consider planning that is somewhat more complex, but essentially more protective of family members. Many clients are in a blended family situation. Statistics indicate ("Blended Family Statistics" by Michelle Blessing) that over 29 million parents (13 percent) are also stepparents to other children, and that 40% of married couples with children in the U.S. are step-couples (at least one partner has a child from a previous relationship; this includes full and part-time residential stepfamilies and those with children under and/or over the age of 18).

(1) In a blended family situation, substantial inequities may result if the credit shelter approach is not used. Potential problems can arise if there is hostility between the executor (perhaps a child by the decedent's prior marriage) and the surviving spouse's family. The executor may try to "extort" consideration for making the portability election, or simply refuse to make it.

(2) The executor may be unwilling to bear the expense of filing an estate tax return to make the election. (Consider drafting the will to provide that the executor would not be required to make the portability election unless the surviving spouse pays the expenses of filing the estate tax return.)

(3) If assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first decedent-spouse's descendants (or may favor some over others of those descendants in ways that the decedent-spouse would not have wanted). If the survivor has children of his or her own, they become the more likely beneficiaries where the spouse is entirely free to act. If the survivor remarries, there is the risk that the new spouse will benefit from the decedent spouse's property.

(4) The first decedent may use a QTIP Trust to control the ultimate disposition of the property, but even if a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the decedent-spouse's descendants, such as requesting and receiving principal distributions from the trust, or making large lifetime gifts using the DSUE amount of the first spouse to die, leaving no exclusion amount to apply against the marginal tax generated by the QTIP, or gifting the income interest, or being entitled

to a substantial estate tax reimbursement at the second death if there is a taxable estate then which includes the QTIP Trust assets under Code Section 2207A —even though the assets are "protected" in a QTIP trust.

(5) Consider using a premarital or post-nuptial agreement in which the parties agree that the surviving spouse will make certain that the decedent's executor makes the portability election.

i. Trusts provide a variety of important benefits, including asset protection, management, and restricting transfers of assets by the surviving spouse (although those benefits can also be utilized with portability by using a QTIP trust rather than a bypass trust). The client should consider carefully: Is the surviving spouse capable of managing assets? Is there fear of the spouse's remarriage or a concern about undue influence?

(1) Spendthrift provisions, providing that trust beneficiaries cannot sell, pledge or encumber their beneficial interests in the trust can be included as a protection against creditors.

(2) The possible future incapacity of a spouse or descendant can be addressed through a trust. If appropriate, special needs provisions can be asserted to guard against the trust assets being used for payments that could otherwise come from public assistance.

3. <u>Some Planning Situations Favor the Use of Outright Transfers to the Spouse and Reliance on Portability</u>

a. The client insists on a strong desire for simplicity and wants nothing to do with any trusts.

b. The spouse is an entirely competent individual who can capably manage assets.

c. The spouses are in a first and only marriage, or it is not a first marriage but there are no children existing by a prior marriage of either spouse.

d. The clients indicate much more interest in securing a basis step-up than getting future appreciation out of their estates, especially if

they believe that any such appreciation will still leave them well short of the applicable exclusion amount.

e. The clients own a residence or other assets that would be difficult to administer in a trust.

f. The additional administrative and income tax costs of having assets in trust such as the additional income tax and ”net investment income tax” that may apply to undistributed trust income outweigh the potential tax and non-tax advantages of trusts. In 2015, trusts with income in excess of $12,300 have that income taxed at the highest tax rates – a threshold substantially below the threshold that individuals, whether single or married, must address.

V. Income Tax Planning – The New Essential Planning Focus

A. Income Tax Planning Will Replace Transfer Tax Planning as a Primary Focus

1. Income tax issues will overtake transfer taxes as the primary area of planning concern for persons of moderate wealth in an effort to minimize current income taxes and maximize the basis step up available on death. For those clients domiciled in non-tax states, i.e., states that are not decoupled, income tax considerations will totally replace estate taxes as the tax planning focus of estate planning.

2. A key issue for clients in this range will be preserving a step up in basis at the death of each spouse. For many clients, a potentially higher capital gains tax in the future, resulting from loss of a second basis step-up for assets that might be held inside a bypass trust may be an unacceptable choice. Clients would prefer to avoid the potential 20% federal capital gains tax, supplemented perhaps by a 3.8% net investment income tax, and possibly state income taxes as well. All of these could result in some clients facing a capital gains rate approaching 30%.

3. A simple will or revocable trust leaving all of the assets outright to the surviving spouse will achieve a basis adjustment at the deaths of both spouses.

4. If a trust is desired for blended family protection or for management or asset protection purposes, using a QTIP Trust or giving the surviving spouse a testamentary general power of appointment should allow a basis adjustment to take place at the surviving spouse’s death.

5. Lifetime gifting may no longer be recommended as a planning technique. For persons of moderate wealth, it will be more advantageous to retain appreciating assets and leave them to heirs, thereby passing on the highest tax basis at death (Code Section 1014). Had the assets been given away during one's lifetime, the basis to the donees would be the carryover basis of the donor (Code Section 1015) most likely leading to more capital gain and net investment income tax liability for the donees.

B. <u>New Planning Considerations Will Focus on Income Tax Issues</u>

1. A very significant part of the value of the moderate wealth client's estate presently consists of appreciated assets. Since these assets will not be subjected to transfer tax, the avoidance of both capital gain taxes and net investment income taxes and passing assets with a stepped-up basis becomes a primary concern.

2. Traditional estate planning techniques used to reduce the value of assets on death, such as family limited partnerships and limited liability companies formed to create valuation discounts for estate tax savings, may be counter-productive to planning in the post- ATRA planning environment.

   a. In a sense, estate planning is upside down from what has been traditionally favored. For persons of moderate wealth below the federal estate tax exclusion, the goal of planning is now include everything possible in an estate at maximum value. Quite a change from the traditional notion of exclude as much as possible, and minimize the value of whatever must be included!

   b. This change in thinking must be embraced not only by the client, but also by the planner who must guide the client. It is an essential consideration in much of what must be done to effectively plan estates in the post-ATRA world.

3. Practitioners have fought for many years to maximize valuation discounts for lifetime gift transfers and for the value of interests in any assets included in a client's estate. A key component of the documentation of many gift plans, and estate tax returns, has been the formal appraisal of the discount applicable to the non-controlling interest in an asset or entity involved. The IRS has resisted these discounts and often challenged them as excessive. With the majority of clients no longer facing a federal estate tax, claiming valuation discounts will provide no estate tax benefit whatsoever, but will reduce the value of the basis step up and thereby increase the future capital gains costs the client's heirs will face.

4. Accordingly, creating asset transfers that generate significant discounts may no longer be desirable. Claiming discounts on transfers at death for minority interest and/or lack of marketability will only serve to reduce the value of property inherited by heirs from a decedent, and the basis of property to the heirs. Where there will not be any federal estate tax at the decedent's death, such discount claims are counter-productive.

5. It is very likely that the practitioner and the IRS will reverse roles in these situations, with the practitioner arguing for lower (or no) discounts. This issue actually may favor the taxpayer, since if an estate is well below the taxable threshold for federal estate tax, it may not be reviewed carefully, if at all by the IRS. Where that is the case, the IRS will not be in a position to challenge the taxpayer's value as "too high" and argue that a discount should be claimed.

6. Consider whether there are provisions in the governing documents of an entity (such as a partnership agreement for a partnership, shareholders' agreement for a corporation or operating agreement for an LLC) that were crafted to allow or encourage discounting (such as below fair market value puts and calls, etc.). Where these are present, consider amending the governing document to minimize or eliminate the discounting opportunity.

   a. Again, this "planning fix" may not be as simple as it appears, since such a suggested revision may not be agreeable to other members of the entity involved if their estates are large enough to face a federal estate tax.

   b. It is possible that some, but not all of the members of the entity reside in a decoupled state where the discounting opportunity would be favorable.

   c. In making any changes to the governing document, consideration should also be given to not reducing asset protection benefits or taking away important non-tax considerations, such as a right of first refusal to keep a family asset in the family.

7. The new post-ATRA planning environment for persons of moderate wealth will give rise to consideration of a new approach to appraisals of property owned by a decedent.

   a. Nothing will change for persons whose estates are over the federal estate tax exclusion –they will continue to seek appraisals to

minimize values that will have the effect of minimizing federal estate tax (and state estate tax, if applicable).

b. For those persons whose estates are under the federal estate tax exemption and who are domiciled in a state that does not have a state estate or other death tax, maximizing the valuations of all estate assets so long as the person's estate remains under the federal exemption will provide the decedent's heirs with the most favorable income tax basis/capital gains result at no estate tax cost.

c. For those persons whose estates fall under the federal estate tax exemption and under their decoupled state's estate tax exemption it makes sense to maximize the valuations of all estate assets so long as the person's estate remains under the state estate tax exemption. This will provide the decedent's heirs with the most favorable tax basis/capital gains result at no estate tax cost.

d. For those persons whose estates fall under the federal estate tax exemption but over their state estate tax exemption – the most difficult issues will arise. What will be the marginal tax impact of the state estate tax compared to the possible capital gains tax savings that high values (and high income tax basis) will result to the decedent's heirs? The heirs may be in the 20% or 23.8% capital gains tax bracket. The highest estate tax bracket for all states with a decoupled estate tax is presently 16% - except Washington which has a top bracket of 19%. While it may be "intuitive" to do everything possible (lifetime transfers, discounting, etc.) to reduce the impact of the immediate estate tax, the "counter-intuitive" planning of maximizing values at death – especially looking at the likely state estate tax bracket – compared to the federal and state income tax impact - may be the better long-term plan.

e. This latter consideration involves the planner in further issues – such as what is the likely disposition by the heirs of the assets owned by the decedent. Will they be immediately sold by the heirs, suggesting the capital gain saving is a primary consideration, or will they likely be held long-term by the heirs, possibly for the duration of their own lifetimes, suggesting that saving transfer tax at the first death should be the primary consideration. Considerations of marginal tax rates, anticipated holding periods, whether tax free conversion options exist (such as a Code Section 1031 tax deferred like kind exchange), etc. will all have to be factored into the planning process.

8. Deciding to disregard discounts on transferred property will be a more difficult issue in decoupled states, where the value of property at death will have a transfer tax impact.

9. Focus on transferring possibly discountable property such as minority interests in S Corporations, limited liability companies and family partnerships to family members in lower income tax brackets so that the ongoing income can be earned there. Where the kiddie tax is not a factor, this planning can have an immediate benefit, and where the kiddie tax is applicable, the child will eventually pass the age limitations forcing the child's income tax liability to use the parents' tax rate. Persons outside of the kiddie tax range may be in the zero to 15% tax bracket for gains on the sale of property.

10. Again, however, this suggestion is not without complication and possible objection. Is the transferred property income producing so that it makes sense to transfer the income-producing potential to persons in lower income tax brackets – or is the property not especially income producing but of low basis to the donor, so that the donor's transfer of the property will deliver a low carryover basis to the donee with little income potential but a possibility of a substantial future capital gain – not the ideal plan in the post-ATRA planning environment.

11. Another planning tool to consider in the quest for higher income tax basis adjustments is the Code Section 754 election.

    a. This election is available for partnerships and LLCs taxed as partnerships. When a partner or LLC member dies, his or her heirs receive the partnership or LLC interest of the decedent with a basis equal to the date of death value of such interest. Code Section 1014. That is the "outside basis" of the partnership interest. The basis of the partnership or LLC in its own assets (the "inside basis") is not affected by the death of the partner or member. Accordingly, sales of partnership or LLC assets will be taxable to the "new" heir partner – despite that person having a high outside basis.

    b. That is where the 754 election comes in. If the entity makes an election to have Section 754 apply, the inside basis of the decedent partner or member's share of the entity's assets is also stepped-up. This allows the heirs to apply the higher basis to the realization of the entity's income, and very possibly avoid income taxation.

    c. The partnership or operating agreement may provide for the 754 election to be made. If it is silent and planning suggests making it would be helpful to the heirs of any partner or member who dies,

amend the appropriate agreement as soon as possible. This may be preferable to awaiting a death, then possibly having to negotiate making the election. Before anyone dies may be the best time to act.

C. Special Planning Concerns Where Trusts Are Used

1. Even where trusts are favored for all of the reasons discussed above (management, asset protection, blended family concerns, etc.) retaining income within a trust is not a favorable planning decision. Due to the highly compressed income tax rates for trusts (i.e. trust income in excess of only $12,300 in 2015 is currently taxed at the highest marginal rate of 39.6%, the 20% marginal rate on long-term capital gains and qualified dividends is reached at $12,300, and that is also the threshold for application of the net investment income tax), distributing trust income currently can be tax advantageous.

2. Compare the compressed rate threshold for trust distributions to the thresholds for individual taxpayers – single persons reach the net investment income tax threshold at $200,000 of adjusted gross income and the 39.6% and 20% thresholds at $413,200 of taxable income in 2015, and married persons filing jointly reach the net investment income tax threshold at $250,000 of adjusted gross income and the 39.6% and 20% thresholds at $464,850 of taxable income in 2015.

   a. While distributing income is a favored planning alternative, it may not always be an available option. What does the governing instrument require with respect to distributions? What about state law?

   b. What do the governing instrument and/or state law say about the distribution of capital gains to any current income beneficiary? As a general rule, capital gains are defined as and allocated to trust accounting principal, and are not readily distributable to income beneficiaries.

   c. In preparing new trusts, it is suggested that the trustee be at least given discretion to distribute capital gains to the income beneficiaries. For existing trusts, look carefully at state laws – is there a "power to adjust" provision allowing a trustee to distribute capital gains if not strictly prohibited by the governing instrument? Is there authority granted to a trust protector or other fiduciary to modify the document to allow such distributions? If not, at least consider decanting the trust to a new trust with broader provisions that would permit inclusion of capital gains in trust income.

d. With all of that said, however, planning should not lose sight of why a trust was created in the first place, and appropriate consideration must be given to any relevant non-tax factors that weigh against making a distribution, prior to distributing trust income solely to save income taxes.

3. Consider a "Sprinkling Trust" to Maximize Income Shifting Opportunities

a. A marital deduction qualified trust (QTIP or general power of appointment) must, of course, limit income distributions exclusively to the surviving spouse. Where a trust is created that is not a marital deduction trust (i.e. a bypass trust or any other trust desired by the grantor) the suggestion is made to include a broad list of current or at least permitted beneficiaries – possibly all of the descendants of the creator of the trust. This may provide trustees who are given the appropriate discretion to make distributions a larger pool of potential distributees in lower income tax brackets.

b. Where appropriate, think of each permitted beneficiary as a "bucket" to be filled from the trust to reach without exceeding the thresholds of the lower tax brackets of these beneficiaries, with the goal of minimizing the overall impact of the family's income taxes.

c. Once again, tax planning is not the only issue here. Are current distributions by the trustees to selected beneficiaries appropriate? Will the beneficiaries be honest in reporting their income situation to the trustees? How will the beneficiaries behave if some receive more generous distributions from the trust than others? View the income distribution opportunity as just that – an opportunity. Not an absolute requirement created by otherwise adverse tax laws.

4. A Beneficiary-Controlled Trust May Achieve the 6 Things Everyone Wants:

a. Control
b. Use and Enjoyment
c. Flexible/Amendable
d. Creditor Protection
e. Tax Savings
f. Avoid Complexity with a "Use Trust"

5. Take Advantage of the 65-Day Rule for Complex Trusts and Estates

a. An election is available under Code Section 663(b) to have an amount paid or credited to a beneficiary within the first 65 days of a tax year to be treated as if paid or credited during the estate or trust's prior tax year. This election gives the trustee the opportunity to use information as to the income status of all beneficiaries for the prior year in planning a distribution to minimize overall family tax burdens.

b. This election can be used in a number of helpful planning situations, such as shifting income to a lower bracket taxpayer, shifting income to avoid an underpayment of estimated taxes by the trust, or moving income to a beneficiary to take advantage of a beneficiary's net operating loss or excess capital loss.

c. Given that most, if not all of the income of a trust will be net investment income subject to the 3.8% tax when the 2015 threshold of $12,300 is passed, the trustee may consider taking advantage of the election to make income distributions in order to reduce the trust's exposure to the net investment income tax.

d. The 65 day election is made by checking the required box on page 2, Other Information, Line 6 of Form1041 for the trust (or estate, if applicable)

6. <u>Take Advantage of a Section 529 College Savings Plan</u>

a. The advance funding of five years of Code Section 529 plan contributions, i.e. the permissible making of five years of annual exclusion gifts to a Section 529 plan in the current calendar year with no detriment for gift tax purposes, has long been used as part of a gift strategy to shift assets out of the donor's taxable estate.

b. If the donor died within the five year period there was a recapture and inclusion in the donor's estate of all or a portion of the gifts made for transfer tax purposes.

c. For those persons who will not face a federal estate tax, the potential recapture is of no consequence. However, with the gifted assets earning tax-deferred or excluded income within the Section 529 plan, there are many years of potential income tax savings available here. This makes the Section 529 contribution all the more appealing in the current planning environment.

VI. <u>What Should be Done with Life Insurance</u>?

A. <u>Why Was Life Insurance Acquired</u>?

1. Persons of moderate wealth will no longer need life insurance to fund the federal estate tax. If that was the only reason life insurance was acquired, and if the client sees no other benefit in retaining it, the client may opt to cancel the policy. There is anecdotal evidence that many persons have done just that in the post-ATRA planning environment.

2. If life insurance was acquired for more "traditional" planning reasons, such as financial security for heirs, education funding, etc. its central focus was not to just be a source of death tax payment, so it remains a viable asset for the purposes acquired. Of course, if the "traditional" reasons have changed, the planner should explore the continued viability of life insurance with the client.

B. <u>The Role of Life Insurance in Any Estate Plan</u>

Life insurance is an asset possessed by virtually all clients to some extent. Assume that there is no need to retain life insurance to pay federal estate tax liabilities. What should be discussed with the client as to the ongoing role of life insurance in an estate plan?

1. The "core" reasons that most persons acquire life insurance were never to use it as a source of tax payment. That was always a secondary objective, and one more appropriate for high net worth families, not families of moderate wealth. The post-ATRA planning world has not changed the reasons most people acquire life insurance, namely:

    a. To create an estate for the financial support and security of a family in the event of premature death.

    b. To provide financial support for a surviving spouse and educational funding for young children.

    c. To provide a readily available source of liquidity to pay debts, address funeral and administration expenses, fund bequests, and, where necessary, fund buyout agreements and other possible contractual obligations.

2. There may be a need to preserve permanent life insurance to pay for state estate tax liabilities for those clients domiciled in decoupled states. This may not be a strong motivating factor for clients who may argue that a surviving spouse may move to a non-decoupled state, or that the state of current domicile may eliminate its estate tax, etc. Some clients may decide that life insurance is the "easy" way to pay for state estate tax liabilities without doing other more complex

planning and maintain a policy for this purpose, while others will embrace the concept of comprehensive planning to avoid state estate taxes and decide that life insurance protection for this purpose is not necessary.

3. Despite the client's best efforts to engage in comprehensive planning, it is possible that not all assets owned by a decedent will achieve the optimal basis step up. In such a situation, life insurance policies benefitting the client's children may be used to pay for the income tax cost the children will bear when the low basis assets are acquired by them and subsequently sold.

    a. It may be advantageous for non-tax reasons to gift some low basis assets during lifetime and accept the carryover basis result. The life insurance payable to the heirs at death can provide a source of income tax payment if these assets are liquidated.

    b. Planning may have favored a bypass credit shelter trust for a surviving spouse which resulted in a basis step up at the first death, but not at the second death when the children inherit property still bearing the first decedent's date of death basis. The sale of the trust assets by the children will result in capital gains to them.

4. Life insurance can be used to provide direct bequests to children from a prior marriage. This may satisfy the client's desire to provide for children without having to address the blended family concerns of trusts or dividing assets between the current spouse and the children of an earlier marriage. Insurance left to the children so that the balance of the insured's estate can be left outright to the surviving spouse may be advisable both to maintain simplicity and achieve a full basis step up for the assets passing to the spouse.

5. Consider recommending the acquisition of additional life insurance as an excellent income tax shelter. Permanent life insurance has significant income tax advantages as the result of the higher income tax rates and the 3.8% tax on net investment income. The build-up of cash value within a permanent life insurance policy is not considered net investment income and is not taxable to the policy owner. For the client in a high income tax bracket unconcerned about federal estate taxes, the favorable income tax treatment of life insurance (i.e. the tax-free build-up of cash values and the ability to access that cash value in a tax-advantaged manner through policy loans) may become an attractive planning option.

6. Access to cash values within a life insurance policy is possible even if the policy is held in an irrevocable trust, assuming the trust is properly drafted.

   a. Language can be included in an irrevocable trust authorizing an independent trustee to borrow the cash value and distribute it to the trust beneficiaries. Such distribution will be income tax free to the recipients.

   b. If one spouse is the insured who creates the trust and the other spouse is the primary trust beneficiary, the borrowing and distribution by the trustee can be for the benefit of the beneficiary spouse – with the insured spouse having no adverse tax effect from the availability of funds to the marital relationship.

   c. So long as the withdrawals do not exceed the income tax basis in the policy based on the premiums paid by the insured, withdrawals to the extent of the income tax basis are not subject to income tax. If additional cash is needed beyond the income tax basis, such cash should be withdrawn as policy loans to avoid income tax implications. For these income tax rules to apply, the policy must not be characterized as a modified endowment contract and should not be surrendered. Should the insured die with the policy in force, any cash value above the income tax basis not previously withdrawn is also not subject to income tax, even if the policy is then characterized as a modified endowment contract.

7. With the concern about the federal estate tax alleviated for the moderate wealth taxpayer, there is less reason to feel compelled to transfer a life insurance policy to an irrevocable trust. Retaining ownership of the policy allows the policy owner to access policy features such as long term care riders or other benefits, and to withdraw cash values as needed without having to look to trustees or "strain" the language of a trust to secure a withdrawal from the policy.

8. As many life insurance sales persons are quick to point out, compare the return generated by a permanent life insurance policy with other investment returns realized by a client through his or her portfolio. The insurance policy return has exceeded interest rate returns on bank and money market funds, is often favorably compared with average dividend yields, and, depending on investment performance, may be favorably compared with the client's portfolio growth. Certainly acquiring or retaining some life insurance as part of a person's investment profile is both a good hedge against the volatility of other investments and now more than ever a tax-favored investment in the post-ATRA world.

C. Use Life Insurance More Aggressively in Planning

1. Consider the situation of a client who created and owns a successful business. Pre-ATRA planning would have suggested giving away pieces of the business during lifetime to avoid federal estate tax and to secure minority interest and other discounts as the gifts are made. Now, consider leaving the business in the hands of the aging owner to assure a stepped-up basis on death, especially if it is likely to be retained by the surviving family members. To protect against any possible state estate tax, have the client acquire a life insurance policy that could be used, if necessary, to cover the state estate tax liability, allowing the business interest to pass untaxed to the intended beneficiary.

2. Similar considerations favoring life insurance ownership would apply if the asset owned by the senior family member was appreciated real estate, rather than a business interest.

3. Where family business succession planning is a potentially difficult issue as one family member is an "appropriate" successor to the business interest and other family members are loved equally but not seen as appropriate business successors, using life insurance to "equalize" benefits among heirs becomes an even more attractive option when the life insurance proceeds left to heirs will avoid estate tax. The business interest can be held until death, thus assuring a date of death basis to the heir and be specifically bequeathed to the intended beneficiary. If other children are residuary beneficiaries of the estate and named beneficiaries of life insurance policies, there is a greater likelihood that equalization can be achieved absent concerns about whose share of the estate will be reduced through tax payments.

D. What Should be Done with Life Insurance Trusts?

1. If the client's estate is approaching the level where state or federal estate tax liability is becoming a possibility, an irrevocable trust to hold life insurance policies and remove them from the taxable estate remains a viable planning option.

2. If the "traditional" non-tax reasons for using a trust are present, an irrevocable trust to hold life insurance policies remains a viable planning option. Life insurance is typically an "easy" asset to persuade clients to gift, since they do not see themselves enjoying the benefits of the proceeds of the policy, and absent a cash need, do not plan to withdraw the cash value. There is no carryover basis or basis step-up issue for a life insurance policy, so no detriment in giving it away during lifetime.

3. In smaller estates, consider whether there is appropriate justification for an insurance trust. There are administrative and tax preparation costs associated with a trust that may not be necessary. Absent the need for the protective benefits of a trust, consider just giving the life insurance policies to heirs while the insured is alive. The insured can keep making premium payments as an annual gift, but the policy will be removed from the insured's estate and any issues of probate, potential claims of the estate's creditors and the costs and administrative burdens of dealing with the policy after the insured's death.

4. The client may have purchased survivorship life insurance and placed the policy into a trust. The purpose of the insurance was specifically to have a fund to pay federal estate taxes at the second death of a married couple. In light of the increased applicable exclusion and portability, the insurance may no longer be needed for that purpose. What should be done with the policy and the trust that holds it?

    a. One answer would be to cancel the policy and have the trustee receive the cash value and administer it in accordance with the terms of the trust. That is an easy solution to suggest – but attention must be paid to the terms of the trust and the responsibilities of the trustee.

    b. Other options might be to consider a tax-free exchange of the policy for a qualified annuity or another insurance policy that could offer more attractive terms (such as faster cash value build up that can be withdrawn) than the second-to–die policy offers.

    c. Keep the existing policy but stop paying additional premiums and make the policy a paid-up policy based on the premiums paid to date.

5. Consider the status of the life insurance policy in the context of the annual administrative ritual of the trustee's receiving the premium notice, receiving a check from the insured, addressing the annual Crummey notice issues, etc. Assuming the client followed the correct Crummey notice procedures, is it necessary to continue to do so?

    a. In the "worst" case, an insurance trust will omit all references to rights of withdrawal and Crummey powers. Here, the premium payments by the insured will be viewed as future interest gifts, and a gift tax return will be required to be filed. Given the applicable exclusion and portability, the typical client will never have to pay gift tax or other federal transfer tax, so dispensing with the

"Crummey dance" may be administratively favored with no adverse consequence.

b. If there is a desire to "respect" the Crummey withdrawal opportunity and avoid the gift tax return filing, consider a written waiver of all future withdrawal rights. Alternatively, it has been suggested that the client sign a one-time waiver stating that all Crummey rights in the future need be only given verbally. If this is done, be sure the trust document permits notices to be given verbally. While these alternatives may not have the "blessing" of established law, can it be argued that these suggestions are "reasonable compliance" with the Crummey procedures – and perhaps most importantly, if there will not be any transfer tax issues, no one will ever have to address any of these issues.

c. Another suggestion could be to simply fund the trust with enough cash to pay the annual premiums for a number of years and ignore the present interest gift tax concerns that the Crummey power is intended to address. If transfer tax will not be an issue for the client, the "excess" gift to fund the trust will not prove to be a problem.

6. Include provisions in a life insurance trust to have it classified as a grantor trust. If the trust will own assets other than cash and life insurance, being deemed a grantor trust will allow the tax-free substitution of properties. Even if the trust will hold only life insurance, grantor trust status is still desirable as the trust will not be subject to the transfer for value rule if there is any transfer of the life insurance policies, even if the transfer is made for consideration.

VII. What Should be Done with Retirement Plan Benefits?

A. The surviving spouse has always been the favored beneficiary of a decedent's retirement plans. A roll over of the decedent's qualified plan or IRA to a surviving spouse enjoys the marital deduction to avoid the estate tax and special rules to defer the income tax on the roll over. Where possible, spouses have typically favored a distribution of a retirement plan to the surviving spouse to take advantage of these tax benefits.

B. The problem has sometimes arisen in the larger taxable estates where the decedent's retirement plan is one of the major assets of the decedent's estate. In these situations, the only way to fund a bypass trust is to use the decedent's plan. When this is done, the applicable exclusion protects the plan from estate tax, but the inability to accomplish a spousal roll over results in commencement of income taxation of the plan benefits based on the minimum distribution requirements for the oldest trust beneficiary.

C. In the post-ATRA planning world, where the decedent's estate will not be subject to taxation, and portability will allow the bypass trust to be avoided, the recommended planning strategy would be to leave the retirement and IRA benefits directly to the surviving spouse to gain the advantages of income and estate tax deferral at the first death, and then to rely on portability to be able to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

D. As in any recommendation of an outright transfer to a spouse, the issues addressed earlier regarding management, blended families, etc. should also be considered in the context of a retirement plan distribution. Where the protection of a trust is desired, the retirement plan assets could be left to a QTIP Trust, but such a designation involves a fair amount of administrative and drafting complexity (Rev. Rul. 2006-26) and will most likely result in a faster required withdrawal of plan assets that will accelerate the income tax liability.

E. Distributions from a retirement plan are income in respect of a decedent, so there is no basis step-up when the decedent dies. The distributions are not considered net investment income, so they are not subjected to the 3.8% net investment income tax. However, the withdrawal of funds from a traditional IRA or qualified retirement plan account is taken into account in determining if the AGI and taxable income thresholds have been reached. Consider converting a qualified plan or traditional IRA to a Roth IRA to both avoid having withdrawals be included in AGI and to avoid required minimum distributions if not needed.

VIII. Changes in the Way Title to Property Should be Designated

A. Traditional pre-ATRA planning for a married couple, especially in a common law state which does not enjoy the automatic split of marital property which is the law in community property states, always involved an uncomfortable discussion about how assets should be titled – ideally an amount of assets in the name of each spouse up to the amount of the applicable exclusion. This was recommended so that the estate of the first spouse to die could take full advantage of the funding of a bypass trust. If this was not done, and the "less propertied" spouse died first, there would be a shortfall in the available exclusions over two deaths, since an "insufficient" amount of property was owned by the "poorer" spouse who had the bad fortune of being the first to die.

B. As the exclusions grew in size, it became increasingly difficult (as well as burdensome and expensive) for many couples to retitle assets, such as real estate holdings, businesses, etc. The spouse with the larger share of assets often was reluctant to retitle his or her holdings to the name of the less propertied spouse. Assets in joint names were recommended to be retitled as

tenancies in common – a recommendation not always embraced by skeptical spouses.

C. Portability has made a great change here. Regardless of the title of assets at the first death, portability will grant the surviving spouse the DSUE of the first decedent spouse, even if all of the assets were titled in the name of the surviving spouse. There is no longer a federal estate tax-driven need to retitle assets to divide them between the spouses in common law states. That said, retitling at least to some extent may be useful and helpful to meet a state estate tax exclusion in a decoupled state.

D. Title to property can now be used to address other important goals "free" of the tax-driven need to fund the bypass trust.

1. Is one spouse an asset protection risk? Is a spouse involved in an activity where there is a possibility of malpractice or other liability claims? Where this may be the case, titling assets in the name of the lower risk spouse does not pose a tax problem where portability will preserve the DSUE of the first decedent, regardless of who is the property owner.

2. Controversy often arose about retitling assets that one spouse was gifted or inherited from his or her own family or brought to the marriage having earned or acquired them prior to the marriage. Where these assets were arguably safe from matrimonial claims of equitable distribution before retitling, changing the title suggested a gift and a withdrawal of the protection from separate property or equitable distribution claims. Portability makes these transfers unnecessary to gain a tax advantage. The advantage exists without the need for retitling.

3. Title to a person's home raises several issues that may be more easily addressed in the post-ATRA planning environment.

a. Property held jointly between spouses as tenants by the entirety generally is given preferential asset protection treatment under state laws. The creditors of one spouse cannot reach the property while the other spouse is alive. The choice of retitling this property to gain the benefit of the bypass trust vs. losing the asset protection benefit was often difficult. The post-ATRA combination of the increased applicable exclusion and portability allows the client to avoid making any change in the form of ownership here.

b. What if the clients took the advice of the planner several years ago and removed a home from tenancy by the entirety status and conveyed it to separate tenancy in common ownership? It is

suggested that the clients reconvey the tenancy in common property to joint names and reestablish the tenancy by the entirety asset protection if permitted by state law.

c. Where a state offers special property tax and other benefits if a homestead exemption can be claimed, not disturbing the title to property qualifying for such an exemption is generally a good idea.

d. Some states (notably New York and California) have become especially aggressive in trying to extend the reach of their income taxes to persons who maintain an "abode" in those states, even if the persons are clearly domiciled elsewhere. Not having to be concerned about preserving a "piece" of title to property to qualify for federal tax benefits will allow persons to concentrate on issues such as domicile designations to make certain that they do not run afoul of aggressive state income tax rules.

e. Title considerations in jurisdictions outside of a person's true domicile may also trigger ancillary probate concerns. To avoid the cost and inconvenience of ancillary probate, consider owning such properties in a revocable living trust. That will avoid probate, but still gain the trust beneficiaries a stepped-up basis when the trust grantor dies, since the property will be included in the deceased grantor's estate (Code Section 2038).

4. Did the client create a QPRT (Qualified Personal Residence Trust) that still has years to run?

   a. If the client is an ultra high net worth person likely to be a federal estate tax payor, leave the QPRT alone.

   b. But for the client of moderate wealth, having a QPRT may not generate any needed tax benefit. Instead, if the client successfully outlives the QPRT term, there will not be any estate inclusion, and the heirs will take a carry over basis from the decedent. This may now be viewed as a detriment to family tax planning.

   c. Consider having the client "violate" the QPRT terms by continuing to live in or use the residence once the term has expired without paying any rent, or find another "retained interest" that will place the QPRT property in the decedent's estate under Code Section 2036. Have the grantor purchase the residence from the trust. Have the beneficiaries exercise a prohibited commutation that will void the QPRT qualification. With no concerns about federal transfer tax liability, suggestions such as these to gain the basis step up are worthy of consideration.

d. Several caveats should be raised here.

i. First, if the client resides in a decoupled state, careful suggesting more assets to be included in the client's taxable estate. Balance the impact of state estate tax imposition vs. capital gains (and possibly state income tax) savings. It may be relevant if the QPRT involves a residence that will be sold by the beneficiaries as soon as possible after the grantor's death, or a residence such as a treasured vacation home that is not likely to be ever sold. If a residence will qualify as the principal residence of someone – the gain exclusion of Code Section 121 may be available (if the criteria are satisfied) to avoid income tax concerns here.

ii. Consider the requirements of the trust, the obligations of the trustees, and the possible concerns of the beneficiaries. If the trustee is willing to act to "break up" the QPRT, be sure all beneficiaries of the trust are in accord – preferably by receiving an acknowledgement in the form of a written consent

IX. **Address the Status of Limited Liability Companies ("LLCs"), Family Limited Partnerships ("FLPs") and Sales to Defective Grantor Trusts**

A. In many cases, these entities (LLCs and FLPs)were formed to remove assets from the transferor's estate and obtain a valuation discount in doing so. In the post-ATRA upside-down planning world for the client of moderate wealth, the estate exclusion and the discount are both negatives.

B. The removal of the asset from the estate eliminates the basis step-up. The discounted value used in transferring the lifetime interest arguably also reduces the value of the asset at death – another limitation of the basis step up. Over the last twenty years there have been numerous cases litigated in the United States Tax Court addressing issues of whether retained rights and interests in family businesses should force inclusion in a decedent's estate. Perhaps taxpayers should look to the arguments raised by the government in these cases, and concede the government position is correct – and embrace it. File a return (non-taxable in the post-ATRA world of portability and large exclusions) and concede the inclusion of the value of the enterprise in the decedent's estate.

1. Should the entity be dissolved? Possibly, but there may be appropriate non-tax management and business identity reasons to continue the entity. Be careful with a dissolution, however. Bear in mind the rule in partnership transactions that the distribution to one partner of appreciated property contributed by another partner within seven years

preceding the distribution will cause the contributing partner to recognize the pre-contribution appreciation, as if the partnership had sold the property at its fair market value on the date of distribution. Code Section 704(c).

2. Does the operating agreement or partnership agreement contain provisions that suggest discounting would be appropriate? If so, consider amending the agreement to remove those provisions so that the value on death will be fair market value, not a discounted value.

3. Consider if the operating or partnership agreement can be modified to assure inclusion of the value of the entire entity in the decedent's estate. Perhaps a retained right to income or controlling management powers, etc. can be used to force Code Sections 2036 or 2038 to become applicable to the decedent's retained powers.

   a. In Estate of Trombetta, T.C. Memo 2013-234, the Court found an "implied agreement" where the decedent, having transferred property to an irrevocable trust, made all decisions with respect to the property, led negotiations in refinancing the property, and retained sole signatory authority in connection with disposing of the property. The Court found the trust property was includible in the decedent's estate despite the transfer to the irrevocable trust.

   b. Continued use of property despite its transfer may be sufficient to require estate inclusion. Estate of Linderme, 52 T.C. 305 (1969); Rev. Rul. 70-155, 1970-1 C.B. 189.

   c. Evidence of continued exclusive use or enjoyment of property can suggest an implied agreement to retain an interest in the property despite its transfer to an irrevocable trust, and force an estate inclusion. Estate of Thompson, 382 F.2d 367 (3rd Cir. 2004).

   d. Consider "accepting" an argument sometimes raised by the IRS when a controlling interest is present to add a control premium to the price of a decedent's asset to increase the value (and the basis to heirs) when the decedent's estate falls below the applicable exclusion threshold. Estate of Salisbury, T.C. Memo 1975-333.

C. If the client utilized the planning technique of the sale to the intentionally defective grantor trust, consider the client's federal estate tax status.

1. If the client is expected to be a federal estate tax payor, leave the grantor trust in place and have the client continue to pay the income tax and "burn off" potential estate taxable assets by doing so.

2. If the client utilized the technique but is not likely to be a federal estate tax payor, consider toggling off grantor trust status (i.e. relinquishing the powers that classified the trust as a grantor trust), especially if the income tax liability will then fall on persons in lower tax brackets, possibly below the thresholds for the highest income tax rates and the 3.8% tax on net investment income.

3. In either event, whether or not the federal estate tax will be an issue, pay attention to the basis of the property the client used to sell to the trust. Absent further planning, the basis to the trust and to the trust beneficiaries is the carryover basis of the grantor, presumably a low income tax basis. If the grantor retained the power of substitution under Code Section 675(4) as the power to make the trust a grantor trust, have the grantor acquire property of equivalent value to what is in the trust, have an independent trustee so certify, and use this power of substitution to exchange the properties. The trust and its beneficiaries will now have property with a current fair market value basis and the grantor will get back the property with the low basis. If the grantor holds the property until death and leaves it to the persons who are the trust beneficiaries, they will obtain a stepped-up basis in that property as well. Code Section 1014.

X. <u>Planning for Persons in Decoupled States</u>

A. <u>More Difficult Considerations to Address</u>

1. The family of moderate wealth may still have to address estate tax considerations when their state of residence is decoupled from the federal estate tax system and maintains its own estate or inheritance tax. Typically, the state exclusion is less than the federal exclusion, and the states other than Hawaii (to date, at least) do not offer portability of their exclusions. Such a situation will require more complex planning to be needed if the family wants to take advantage of the available state exclusions.

   a. Planning complexities may be compounded by the fact that some states will change their laws to either reduce or eliminate the taxes, while others may go in the opposite direction and institute a tax or reduce an existing exemption.

   b. Another complexity is the domicile of the survivor. If the survivor relocates to a state that does not have an estate tax, planning that was done may not have been necessary, or planning that was never done may be rewarded. Uncertainty rules here!

2. Planning in decoupled states suggests using a bypass trust at the first death to capture the amount of the available state exclusion so that it avoids taxation at both deaths.

   a. The advantage of this choice is the absence of state taxation on the excluded property. Be careful of formulas here. If the formula used is to tie the amount of funding of the bypass trust to the federal exclusion, the state estate tax liability at the first death will approach $475,000 under current law. If the formula is tied to the state estate tax exclusion, the state estate tax liability at the first death will be zero.

   b. The disadvantage of this choice to use the bypass trust at the first death is the lack of a stepped-up basis at the death of the surviving spouse and the possibility of future capital gain taxation at a rate higher than the state death tax rate. The mathematics of all of this can become quite complex if time value of money issues are added to the analysis. When will the survivor die? When will property be sold? How much estate tax will be deferred? How much capital gain tax will be paid? These are all issues that can be addressed in these situations.

   c. Some clients are likely to reject planning for these complexities and opt for the more "simplified" and less costly planning suggested by the federal estate tax rules. Their attitude may be that if state taxes are due at the second death of a married couple, both spouses will be dead at the time, and let the children worry about it. They may say that if the surviving spouse lives long enough after the first death, state and federal laws may change dramatically, the survivor may relocate, etc. – so why spend a lot of money and planning anguish now when so much is unknown. Can it be said that they are wrong?

   d. Other clients will object to paying any tax that is not absolutely unavoidable, so they will embrace the bypass trust concept. For these clients, all of the issues of gifting, discounting, etc. that can be largely dismissed in addressing the federal exclusion and portability are brought back into focus and need to be addressed if the state estate tax becomes a matter of important concern.

   e. Lifetime gifting in decoupled states is a favored planning technique. The suggestion would be to pay attention to basis where possible to avoid giving donees the lowest basis assets that will result in future capital gains tax.

f. Some states permit a state-only QTIP election to be made to take advantage of the marital deduction for state estate tax purposes, even if no such election has been made for federal purposes. Others prohibit such an independent election. Still others require the federal choices to be followed, but if no federal return is filed, a state QTIP election is allowed. Where permitted, consider use of the state-only QTIP to address the decedent's excess assets over the state excluded amount – especially if an outright transfer to the surviving spouse is not favored.

XI. Summary: Key Estate Planning Techniques in the Post-ATRA Environment for Estates of Moderate Wealth

A. Where trusts are used, consider giving the beneficiary a lifetime or testamentary general power of appointment to achieve a basis step-up at the beneficiary's death.

1. If the beneficiary is likely to be a federal estate tax payor, suggest to the beneficiary that disclaiming such a power may be advisable.

2. Alternatively, consider use of the more complex and sophisticated approach of using the "Delaware Tax Trap" (Code Sections 2041(a)(3) and 2514(d)). This involves providing in a trust that the beneficiary is given a limited power of appointment that includes the power for the beneficiary to grant a presently exercisable power of appointment to another person (even a limited power to appoint property in further trust) that can further postpone the vesting of the appointed property. Where this power is exercised by the trust beneficiary, the appointed property will be included in the beneficiary's gross estate - exactly the result desired when the estate will not be subjected to the federal estate tax but seeks a stepped-up basis for the trust assets, and a result easily avoided when the estate is "too large" by having the beneficiary take no action to "spring" the Delaware tax trap. The beneficiary controls this decision. Clearly if this technique is to be used, the beneficiary should seek sophisticated tax advice before proceeding.

B. For spouses, be sure to address the portability election. Do not fail to file Form 706 to make the necessary election.

C. Where maximizing gifts to grandchildren is desired, remember that the GST exclusion is not portable. Have the first decedent spouse be the transferor to the grandchildren. This can be done either directly, or by creating a QTIP trust for the benefit of the surviving spouse and making the reverse QTIP election on the Form 706 filed for the first deceased spouse. That will make that spouse the transferor to the grandchildren and the surviving spouse will enjoy the lifetime benefits of the QTIP Trust and will have his or her full

GST transfer opportunity still available. Code Section 2652(a)(3)(b). A further advantage of this reverse QTIP trust planning is that the assets will receive a stepped-up basis at the deaths of each spouse. If it is desired to assure that the surviving spouse will also be a transferor to grandchildren, consider creating a lifetime QTIP for the benefit of the surviving spouse with remainder to grandchildren. Code Section 2523(f). Such a trust will be included in the estate of the beneficiary spouse, that spouse will be the transferor of the property for GST purposes, and the trust assets will obtain a potentially stepped-up basis at the death of the spouse for whose benefit the lifetime QTIP was created.

D. Consider flexible planning that gives the surviving spouse the option of what planning to select at the first death. This is a useful suggestion for both the federal estate tax standing alone and for spouses who may live in decoupled states with their own state estate tax.

1. Use an outright transfer to the surviving spouse with a disclaimer provision (by the spouse) leading to a bypass trust where the spouse is a primary (or sole) lifetime beneficiary. While apparently a "simple" choice, concern is often expressed as to whether the surviving spouse will actually proceed with a disclaimer. A qualified disclaimer must be made within 9 months of the decedent's date of death. Where a disclaimer plan is used and the surviving spouse is the beneficiary of the bypass trust to be funded by the disclaimer, the spouse may not be given a limited power of appointment over any trust which can be affected by the spouse's disclaimer. Reg. 25.2518-2(e)(2).

2. Alternatively, leave assets in a manner such that the executor of the decedent's spouse can elect QTIP treatment to the extent desired, with the balance of property possibly passing to a bypass trust or to some other beneficiaries – a so-called partial QTIP or "Clayton QTIP" provision. Reg. 20.2056(b)-7(d)(3) and 7(h) Example 6.

    a. This option takes the planning choice away from the spouse and puts it in the hands of the executor who may be more "objective", especially if there are blended family considerations that could cause a conflict for the surviving spouse. The Regulations permit partial QTIP elections. Reg. 20.2056(b)-7(b)(2)(i).

    b. Such a provision could be helpful in a decoupled state estate tax situation as well. If an automatic extension of time to file Form 706 is obtained, the executor has 15 months from the decedent's date of death to make this decision.

c. If desired, trusts created in this manner could give the surviving spouse a limited power of appointment. Code Section 2056(b)(7)(B)(ii)(II).

3. The choices to be made in a flexible plan that would involve the funding of a bypass trust could include allowing discretionary beneficiaries other than the spouse so that the possibility of distributing income to persons in low tax brackets will be available. The trust could also encourage the trustee to distribute the most highly appreciated assets to the surviving spouse so that they will enjoy a stepped-up basis upon the surviving spouse's death.

E. Where trusts are used, bear in mind the highly compressed tax rates imposed on trusts, and wherever possible and appropriate allow discretion in distributing income and principal to the trust beneficiaries.

F. If a bypass trust is utilized, bear in mind that the trust assets may be highly appreciated at the death of the surviving spouse with no basis step–up to the trust beneficiaries at the second death. Pay careful attention to the assets used to fund such a trust. For the family of moderate wealth, appreciation of assets should be favored in places other than the bypass trust.

G. The moderate wealth client whose assets may be approaching the threshold where the federal estate tax could apply must continue to pay attention to asset values in relation to the law. The client could utilize a program of annual gifting to stay below the threshold if that will be sufficient, or consider more involved planning (such as GRATs, for example) to restrict appreciation from overtaking the federal estate tax threshold.

H. For persons living in decoupled states, be sure to address the issue of how, if at all, the state exclusion will be addressed. If there is state death tax paid at the death of either spouse, be sure it was an anticipated consequence of the estate plan selected, and communicated to interested family members before anyone has died. Be careful of "surprised" and angry heirs who thought they were told there would be no death tax when their loved one died. That comment may be true of federal estate tax, but not necessarily state death tax.