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Estate Planning in 2015

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Gift and Estate Tax Exemptions and Rates

Over two years have passed since the American Taxpayer Relief Act of 2012 (ATRA) was passed, setting the unified Federal gift and estate tax exemption and the generation-skipping transfer tax (GST tax) exemption at $5 million, indexed for inflation. Estate and gift taxes and GST taxes are all set at a flat 40% rate. For 2015, the gift and estate tax exempt amounts and GST tax exempt amount equal $5.43 million ($10.86 million for married couples). These amounts are indexed for inflation and will likely increase by $90,000 or more every year.

Portability - Simplifying Estate Planning?

ATRA also made "portability" permanent – a great benefit to married couples. If a spouse dies without exhausting his or her lifetime gift and estate tax exemption, so long as the decedent's executor makes the proper election on an estate tax return, the unused exemption is credited to the surviving spouse for use during life or at death. The deceased spouse's unused exemption at the survivor's death will be combined with the survivor's own estate tax exemption to offset any estate tax liability in the survivor's estate. However, unused GST exemption is *not* portable; if it is not used by the decedent, it is lost.

The combined gift and estate tax exemption, along with portability, allow many married couples to simplify their estate plan and still avoid estate taxation at the second death. For couples with less than $10.86 million in net worth, an "all to the other" approach, which relies on portability to cover any estate tax at the second death, may be the simplest way to meet the couple's estate planning objectives (assuming the spouses do not wish to provide directly for children or other family members, friends, or charities). This provides the surviving spouse with the greatest flexibility and a second stepped-up income tax basis in assets held at the surviving spouse's death. Careful thought is still required to determine how assets should ultimately pass to the next generation after the surviving spouse's death.

When "All to the Other" May Be All Wrong

Although portability offers an easier option for married couples, there are many instances in which this approach may not be recommended:

▶ **Blended Family or Other Intended Beneficiaries.** For couples with children from a prior partner, the traditional "QTIP" Trust or Bypass Trust may still be a better strategy to ensure that the children of the first-to-die are remainder beneficiaries at the second death. The survivor may not change the final beneficiaries of the trusts. Both the QTIP and Bypass Trust can also be used to provide for other family members, friends, or charities chosen by the first-to-die. While the Bypass Trust allows all appreciation between the deaths of the two spouses to pass free of estate tax at the second death, the use of the Bypass Trust will prevent a step-up in income tax basis at the second death.

▶ **Creditor Issues.** The "all to the other" approach provides that the assets of the first-to-die will be allocated to the survivor. Because the survivor has full control over the assets, the survivor's creditors can also reach the assets. If there is concern about creditors of the surviving spouse, use of a QTIP Trust or Bypass Trust may still be ideal.

▶ **Dynasty Planning.** Because portability does not apply to the GST tax exemption, the GST tax exemption of the first-to-die is lost with "all to the other." If a couple wishes to engage in multi-generational planning, then dynasty trusts designed to fully utilize the GST tax exemption of each spouse should be used.

Income Tax: The Unexpected Estate Planning Focus

ATRA increased the top federal individual income tax rate to 39.6% and the top capital gains rate to 20%. The Affordable Health Care Act added the 3.8% net investment income tax. For California taxpayers, the top state individual income tax rate has increased to 13.3%.

What do these increases in income taxes mean for estate planning? Previously, the focus for estate planning had been on reducing the taxable estate, as top estate tax rates significantly exceeded income tax rates. However, the current environment has made income taxes a new focal point for estate planning. High net worth individuals may prefer to engage in strategies during life that both reduce their total income tax and transfer wealth to their descendants with as little transfer tax as possible. Some techniques include:

▶ **Shifting income.** Gift high income-producing assets to a trust that distributes taxable income to a beneficiary in a lower tax bracket.

▶ **Avoiding phase-outs.** Reduce gross income to avoid the phasing out of itemized deductions and personal exemptions by creating Charitable Lead Annuity Trusts (CLAT). In a low interest rate environment, CLATs also offer donors the opportunity to pass appreciation in assets in excess of the IRS assumed earnings transfer tax free to the next generation.

▶ **Delaying Capital Gains Taxation**. Gift appreciated assets that are to be sold to a Charitable Remainder Trust (CRT), a tax exempt trust. A sale by the CRT avoids immediate capital gains taxation and 100% of the proceeds are reinvested. Distributions from the CRT each year will be taxed to the beneficiary, but may avoid income taxation at top rates.

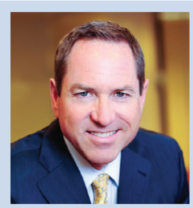
▶ **Selling instead of gifting.** Use installment sales to defective grantor trusts and zeroed-out Grantor Retained Annuity Trusts, preserving the gift and estate tax exemption amount for use against assets in the decedent's estate while still reducing the taxable estate.

▶ **Exploit Basis Step-up.** Cause low basis assets to be included in a decedent's nontaxable estate, receiving a step-up in basis and reducing capital gains tax at a subsequent sale.

Conclusion

Portability may allow simpler estate planning for some couples, but for others with significant wealth, blended families or unique goals, portability may not be the answer. In addition, the narrowed gap between gift and estate taxes and income and capital gains taxes has created a new focus on income tax planning. A check-up with your estate planner may be advised to ensure that your plan takes appropriate advantage of today's laws and cutting edge techniques.

Timothy J. Kay



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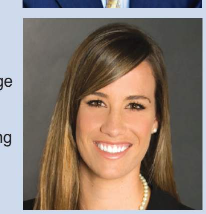

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