Trusts & Estates

NEWS

MURTHA CULLINA

INCOME AND ESTATE TAXES

THE NEED FOR A HOLISTIC APPROACH TO A CHRONIC CONDITION

OCTOBER 2014

The Trusts & Estates Group at Murtha Cullina is pleased to provide clients and friends with information about topics of interest in the estate planning area.

If you have questions about the issues addressed in this newsletter, or any other matters involving estate planning issues, please feel free to contact any of the following attorneys:

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For many of our clients it is a fundamental truth that ever-changing income taxes and estate taxes are equally detrimental to the financial well-being of the family unit. Accordingly, a holistic and evolving approach is necessary to mitigate the potential ill effects resulting from the tax policies of the state and federal governments. This article will explore the shifting roles of income and estate tax planning and certain techniques that should be considered in light of recent changes.

PAST PLANNING

In the past, the goal of estate planning for wealthy individuals was to aggressively transfer assets out of the estate during life to avoid burdensome death taxes. The economic cost of these transfers was the loss of the step-up in basis to fair market value that the Internal Revenue Code (the "Code") allowed for assets included in the estate. This stepped-up or higher basis could offset capital gains tax on a future sale. At the time the tradeoff was accepted because estate tax rates were significantly greater than income tax rates. Typical strategies involved the leveraged use of the annual gift tax exclusion and the lifetime Applicable Exclusion Amount. It is important to note that the state of residence of the individual for whom the planning was being performed as well as that of the beneficiaries did not significantly impact the overall strategy because the large gap between transfer tax rates and income tax rates existed across all states. Accordingly, estate planning recommendations across the United States were relatively consistent.

IMPETUS FOR CHANGE

The enactment of the American Taxpayer Relief Act of 2012 ("ATRA") and the imposition of the 3.8% Medicare contribution tax (the "Medicare Tax") on unearned passive income that was a product of the Health Care and Education Reconciliation Act of 2010 was the impetus for change in estate and income tax planning at the federal level. Further, many states increased their income tax rates and reduced or repealed their transfer taxes, which likewise contributed to the change.

THE CURRENT RATES

An examination of the current income and estate tax rate structure quantifies the reasons for the change in strategy.

FEDERAL ESTATE TAXES

- The top estate, gift, and generation-skipping tax ("GST") rate is 40%;
- The Applicable Exclusion Amount as indexed for inflation in 2014 for each person is $5.34 million;
- The federal estate, gift and GST tax systems are unified with respect to the Applicable Exclusion Amount; and
- The provisions are now permanent and will no longer be subject to the uncertainty of

the "sunset" of these rates and exemptions as was previously the case.

FEDERAL INCOME TAX RATES

- The highest ordinary income tax rate is 39.6%;
- The long-term capital gain tax rate is 20%;
- The qualified dividend income tax rate is 20%; and
- The Medicare tax on net investment income is 3.8%.

ANCILLARY FEDERAL ESTATE TAX CONSIDERATIONS

There are two additional federal estate taxes implications that facilitated the change in planning focus:

- The Applicable Exclusion Amount is indexed to inflation. Consequently in the ten years under reasonable assumptions if inflation were low, that amount could rise to as much as \$5.7 million and in twenty years \$6.4 million. If inflation were high, those amounts could be \$8.2 million and \$14.6 million respectively.
- The concept of "portability" was introduced. In summary, this concept allows a surviving spouse to utilize the unused Applicable Exclusion Amount of a deceased spouse, thereby effectively doubling the Applicable Exclusion Amount of the survivor for estate and gift tax purposes.

FUTURE PLANNING

Given the current and potential future Applicable Exclusion Amount it is apparent that fewer estates will be exposed to estate tax and there will be less of a focus on lifetime transfer planning. In fact, given the potential for a federal long-term capital gain rate of 20%, a Connecticut effective rate as high as 6.7% and a Massachusetts effective rate as high as 5.2%, every dollar of step-up in basis available that does not generate exposure to the future assessment of an estate tax should be fully utilized. Beyond full utilization, given a 39.6% federal income tax rate plus the 3.8% Medicare tax rate and a possible 6.7% Connecticut income tax rate or a 5.2% Massachusetts income tax rate, wealthy individuals should again explore family income shifting strategies. Accessing the lower income tax brackets of family members can provide significant savings. Further, given that some states such as California have income tax rates as high as 20%, effective planning will consider the situs of taxable entities such as trusts or family businesses as well as that of beneficiaries and owners.

PLANNING CONSIDERATIONS

In the context of planning for the full utilization of the Applicable Exclusion Amount, the following should be considered.

- Current size of the gross estate;
- Current asset makeup of the estate and the potential for step-up in basis in those assets;
- Potential appreciation and cumulative return on assets;
- Life expectancy of the client;
- Lifestyle of the client, including spending habits and the inclination for charitable contributions;
- Contemplation of the taxable disposition of assets;
- State of residence of the client and the beneficiaries and contemplated changes; and
- State income and transfer tax implications.

INCLUSION TO MAXIMIZE APPLICABLE EXCLUSION AMOUNT

Given the increasing federal and state income tax rate environment, maximizing inclusion and the related step-up in basis may require the reversal of strategies which were previously put in place to minimize estate inclusion.

EXISTING PLANNING ARRANGEMENTS

- <u>Asset Swaps</u>. In 2011 and 2012, Congress contemplated a reduction of the Applicable Exclusion Amount to 2001 levels. Many wealthy individuals responded by making large gifts to trusts to lock in their use of the higher Applicable Exclusion Amount. Most of those trusts contained provisions that allowed the grantor to swap the assets of the trusts with assets retained by the grantor. Part of the strategy was to transfer assets that had the greater potential for appreciation while retaining the assets that were less likely to appreciate in hopes of mitigating future estate taxes. Accordingly, the assets with the most exposure to future capital gain were placed in the trust. Grantors may now consider exercising the power to swap assets to bring the higher appreciating assets back into their estates in exchange for the lesser appreciating assets to gain the benefit of the step-up, thereby reducing their beneficiaries' future capital gain exposure.

- Valuation Discounts. A strategy employed in planning for family businesses was to transfer portions of ownership to family members utilizing valuation discounts based upon the minority ownership position and the lack of marketability of the business interest transferred. In addition, having the family head of the business move from a majority ownership position to a minority position would generate a significant estate tax savings because of the application of the previously mentioned discounts to the value of the interest in the estate. If that family member now has available Applicable Exclusion Amount, it may be wise to return him or her to that majority position to eliminate the discount and perhaps gain added basis in the form of a valuation premium.

NEW PLANNING ARRANGEMENTS

There are some additional strategies that will cause estate inclusion and a step-up in basis.

- General Powers of Appointment. If a decedent retains a general power of appointment at death (a "Testamentary Power"), then for transfer tax purposes, he or she is treated as owning the assets subject to the power and these assets will receive a step-up in basis. A general power of appointment is defined in the Code as a power exercisable in favor of: (i) the power holder; (ii) his or her estate; (iii) his or her creditors or (iv) creditors of his or her estate. Planning opportunities exist in conjunction with the granting of Testamentary Powers which will cause estate inclusion. This strategy can also be useful in the context of GST planning where inclusion in the estate of a beneficiary with available Applicable Exclusion Amount will minimize overall family transfer taxes. A word of caution: a narrow Testamentary Power may be necessary to limit unintended consequences of the exercise by a beneficiary of a broad general Testamentary Power contrary to the wishes of the Grantor. A formula clause to quantify the limits of the Testamentary Power may be an option but there are inherent risks of challenge by the IRS. Finally, a Trust Protector could be added to the Trust and be granted the authority to modify the terms of a Testamentary Power to make it a general Testamentary Power if circumstances warrant the change.

- Use of Portability. Portability can be used to provide a step-up in basis to the extent available on all assets owned by both spouses on the death of the survivor of them. In a traditional plan for wealthy individuals, bypass trusts were frequently employed. On the death of a spouse, a trust was created and funded with the full Applicable Exclusion Amount of the deceased spouse. The assets in this Trust were included in the deceased spouse's estate for tax purposes and received a step-up in basis. Although the surviving spouse had access to the assets as a beneficiary of the trust, they were not included in the surviving spouse's estate on death and therefore did not receive a step-up in basis. An alternative would be to use portability to maximize both spouses' Applicable Exclusion Amounts in the surviving spouse's estate and, assuming continued appreciation after the death of the first spouse to die, all assets would receive a step-up in basis at the second spouse's death. A cautionary note: there are some benefits to bypass trust planning that will be forgone, such as creditor protection and mitigation of "new spouse" issues.

CLOSING THOUGHTS

It has always been the case that in the context of the federal and state tax structures, planning is necessary to produce savings. As a result of the changes in the federal and state estate and income tax laws, including the rate structures, more finely tuned planning will be required to reach that same threshold of savings. Accordingly, you should consult with your Murtha Cullina attorney to explore ways to ensure that your family's tax savings are optimized.

MURTHA CULLINA WELCOMES NEW ASSOCIATES

Murtha Cullina's Trusts & Estates group is pleased to welcome two new associates, Shera G. Golder and Robert A. Heinimann, Jr.

Shera has experience preparing sophisticated tax and estate plans for high net worth individuals and closely held businesses. She has also worked on federal and state gift tax returns, as well as charitable trusts.

Prior to joining Murtha Cullina, Shera served as an associate at Cummings & Lockwood in West Hartford. She also performed volunteer legal work for the Jewish Community Foundation of Greater Hartford. Shera earned her Bachelor of Arts from the University of Michigan, and her J.D., with honors, from Boston University School of Law. She is admitted to practice in Connecticut, Massachusetts and California.

Robert A. Heinimann, Jr. will be responsible for the development and implementation of estate plans for clients. His practice will also include estate and trust administration, probate proceedings, tax planning and business succession planning.

Robert has experience in conservatorship proceedings in Connecticut Probate Districts, as well as the Title XIX application process. He also has experience counseling clients in contested trusts and estates matters.

Prior to joining Murtha Cullina, Robert served as a Senior Associate at R. Eugene Torrenti, LLC and Associate at Paragon Trust Company. He earned his Bachelor of Arts from The College of The Holy Cross, and his J.D., with honors, from Quinnipiac University School of Law. Robert is admitted to practice in Connecticut and New York.