Estate Tax Relief, Income Tax Headache:

Estate Planning and the American Taxpayer Relief Act

Thanks to the American Taxpayer Relief Act, a married couple with a properly structured estate can pass more than $10 million free of federal estate tax. But potential income taxes are daunting. Here's how to avoid creating one big tax liability while reducing another.

By Stephen M. Margolin and Lindsey Paige Markus

The American Taxpayer Relief Act of 2012 ("ATRA") was signed into law on January 2, 2013, making several of the Bush era tax cuts permanent.[1] At first glance, ATRA looked taxpayer friendly. But upon closer examination, a minefield came into view – not of potential estate tax, but rather of income tax.

Depending on the year of death, a decedent may pass a certain amount of assets free of the federal estate tax (i.e., the estate tax exemption).[2] In addition, during an individual's lifetime, she may gift assets through an annual gift exclusion ($14,000 per person in 2013 and 2014) and a lifetime gift exemption (which reduces the estate tax exemption at death).[3] Transfers to a "skip person" (a grandchild) are also subject to generation skipping transfer ("GST") limitations.[4]

ATRA fixed the federal estate tax exemption, lifetime gift exemption, and GST exemptions at $5 million, adjusted for inflation ($5.25 million in 2013 and $5.34 million in 2014).[5] In addition, ATRA increased the maximum estate tax rate, gift tax rate, and GST rate at the federal level to 40 percent.[6] Thus, a married couple with a properly structured estate plan had the opportunity to pass a $10,500,000 estate tax free in 2013 – but the potential income tax consequence is daunting.

This article places these estate and income tax changes (with apologies to Clint Eastwood and Sergio Leone) in

1. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102 (2013).
2. 26 U.S.C. § 2010 (2013) (providing the "applicable exclusion amount" estate tax exemption). All references are to the Internal Revenue Code unless otherwise stated.
3. 26 U.S.C. §§ 2503(b), 2010(c) (2013); Rev. Proc. 2012-45 I.R.B.
4. 26 U.S.C. § 2642 (2013); American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 (2013).
5. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 (2013).
6. 26 U.S.C. § 2001(c) (2013).

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the framework of "*The Good, the Bad and the Ugly.*"

The good – "portability" is permanent

Portability allows a surviving spouse to take advantage of the unused portion of the federal exemption of a predeceased spouse, thereby providing the survivor with a larger exclusion amount. The portability amount, however, was fixed at $5 million and is not adjusted for inflation.[7]

For example, David had a taxable estate of $3 million when he died in January 2012. His wife, Diane, filed a 706 federal estate tax return electing to capture his unused exemption of $2 million. When Diane died in December 2013, David's unused exemption of $2 million was added to Diane's unused exempt amount of $5.25 million, and Diane was able to pass a $7.25 million estate tax free.

Portability, or the deceased spousal unused exclusion amount, is only available to the surviving spouse if an election is made on a timely filed estate tax return.[8] If the surviving spouse is predeceased by more than one spouse, the exclusion amount would be limited to the lesser of the $5 million exemption or the unused exclusion of the last deceased spouse.

However, portability does not apply to GST exemptions. In addition, portability is not applicable to state tax exemptions. So residents of states, like Illinois, that are subject to estate tax do not have this exclusion.

The bad – income taxes increases for some

Unfortunately for taxpayers, ATRA increased the 15 percent capital gain, qualified dividend, interest, and other investment income tax to 20 percent for various filers (married taxpayers with $450,000 or more in taxable income, single filers with $400,000 or more in taxable income, and trusts with income over $11,950).[9] The capital gains tax increased to 25 percent for precious metals, antiques, artwork, etc.[10]

Further, the Health Care and Education Reconciliation Act of 2010 ("2010 Tax Act"), which became effective in 2013, imposed a Medicare tax of 3.8 percent.[11] This Medicare tax applies to the lesser of investment income (capital gains, dividends, interest, rents, etc.) or adjusted gross income over $250,000 for married taxpayers, $200,000 for single filers, and $11,950 for trusts.[12]

No federal estate tax – *good*! Thus, assume when David died he had a traditional A/B trust that created an A trust ("marital deduction trust") and a B trust ("credit shelter trust") (see Figure 1).

David died in 2012 (when the exemption amount was $5.12 million) with a $3 million estate, so David's entire estate was allocated to the credit shelter trust. Upon David's death, the assets in the credit shelter trust received a step-up in basis to the fair market value of $3 million. From the date of David's death to December 2013 when Diane died, the assets in David's credit shelter trust appreciated to $4.5 million. The assets in David's credit shelter trust and all appreciation of them pass federal estate tax free to the next generation.

At the time of Diane's death in 2013, the value of her estate was $4.5 million, less than the applicable exclusion amount of $5,250,000, so no federal estate tax was due.

Potential income tax – *bad*! Upon Diane's death, any amount in David's marital deduction trust and the $4.5 million in Diane's estate get a basis adjustment equal to its fair market value at Diane's date of death.[13] In other words, there was a "step up" in basis to fair market value, avoiding income tax on the sale or disposition of these assets.

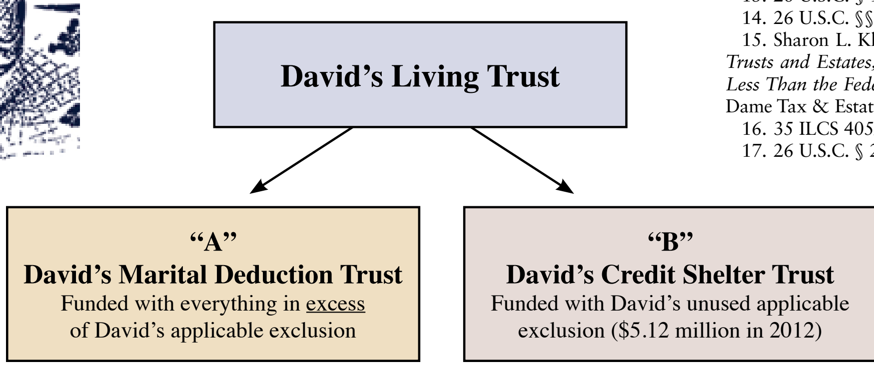
However, the amount in David's credit shelter trust does not get a step up in basis since Diane had no incidences of ownership or control over the credit shelter trust.[14] Thus, the $1.5 million ($4.5 million minus $3 million) gain in David's Credit Shelter Trust was potentially subject to a 23.8 percent tax (capital gain and Medicare), or $357,000.

The ugly – state tax consequences

In addition to the federal income tax, various states hungry for additional revenue also get in on the act. Many states have decoupled from the federal estate tax regime and impose a state level estate tax.[15] In December 2011, Illinois passed legislation setting the Illinois estate tax exemption at $4 million for 2013 and beyond.[16]

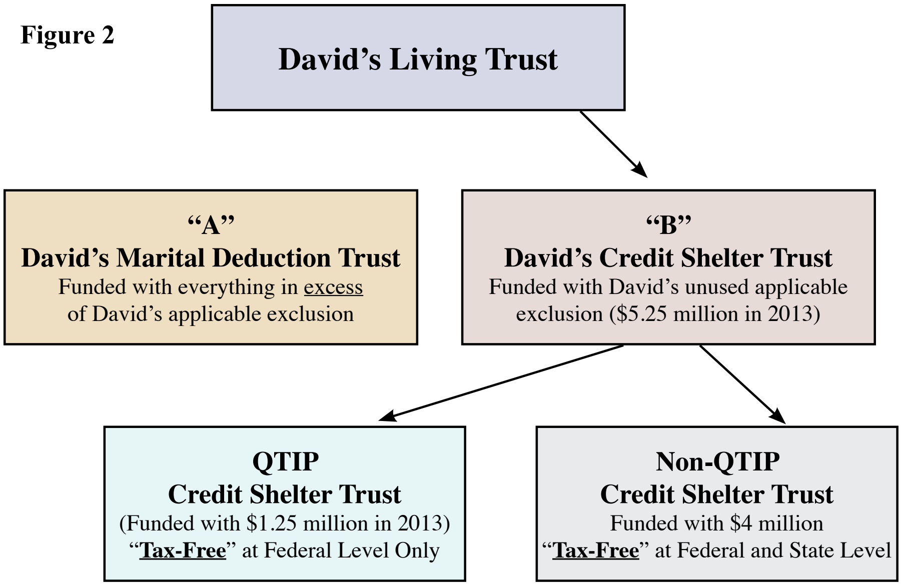
Absent proper planning or updating outdated documents, an Illinois estate tax may be due on the first spouse's death, even if no federal estate tax is due. When an estate is paying estate tax at both the federal and state levels, federal law provides a deduction for state death taxes paid.[17] Therefore, the amount of the federal estate tax depends, in part, on state estate taxes paid and involves a circular calculation. When an estate is only paying state level estate taxes and is not receiving the deduction at the federal level, the net effective state tax can be very high.

Figure 1



7. 26 U.S.C. § 2010(c)(4) (2013).
8. 26 U.S.C. § 2010(c)(5)(A) (2013).
9. 26 U.S.C. § 1(h) (2013).
10. *Id.*
11. 26 U.S.C. § 1411(a) (2013).
12. 26 U.S.C. § 1411(b) (2013).
13. 26 U.S.C. § 1014(a) (2013).
14. 26 U.S.C. §§ 2035, 2036, 2038, 2041 (2013).
15. Sharon L. Klein, *State Law Current Developments: Income Tax Impact on Trusts and Estates, Decanting, Estate Tax Problems When the State Exemption is Less Than the Federal Estate Tax Exemption*, Ch. 16, Thirty-Eighth Annual Notre Dame Tax & Estate Planning Institute, South Bend, IN, Sept. 21, 2012.
16. 35 ILCS 405/2(b)(iii) (2013).
17. 26 U.S.C. § 2058(a) (2013).

Figure 2



Assume David, an Illinois resident, died in 2013 with a $5.25 million estate. David's credit shelter trust would be fully funded with the federal exemption of $5.25 million, but only $4 million would pass estate tax free at the state level. The balance of $1.25 million is subject to a graduated estate tax to the state of Illinois, translating to an estate tax to the state of Illinois of $357,143.[18]

To prevent such tax, the trustee may divide the credit shelter trust into two trusts: (1) one trust with $4 million, which is exempt at the federal and state level; and (2) a second trust with $1.25 million, which is exempt at the federal level but includes a state qualified terminable interest property ("QTIP") provision.

The QTIP provision defers Illinois taxation on the amount in excess of the state exemption ($1.25 million in 2013) until the survivor dies.[19] The QTIP provision defers the payment of $357,143 in taxes to the state of Illinois.[20] If the surviving spouse uses all of the money in the QTIP sub-trust prior to the death of the surviving spouse, or moves to another state, no estate tax is owed to the state of Illinois. See Figure 2.

There are states, such as New Jersey and New York, that do not permit a state QTIP provision, and electing the full federal exemption in the credit shelter trust may trigger enormous state estate tax.[21]

In addition to the steep estate tax rates, Illinois also imposes a 5 percent income tax, including on capital gains.[22] Further, in the states that have decoupled from the federal estate tax exemption, like Illinois, there is no state portability.

The dilemma

Because the estate tax exemption is so high ($5.34 million in 2014), the demand to protect against federal estate tax has lessened to perhaps 1 percent of the population.[23] However, the estate tax levied by various states with differing exemptions must be considered.

The traditional A/B trust remains a useful choice to minimize potential estate tax, both federal and state, and to preserve the first decedent's $5,340,000 generation-skipping tax exemption, which portability does not cover. In addition, the credit shelter trust is useful for non-tax reasons, including: (1) protecting family assets; (2) allowing "spray" provisions to various family members; (3) allowing flexibility of distributions; and (4) ensuring certainty of disposition to specific persons.

However, for married couples with less than $10.68 million in assets in 2014, the increased capital gains tax rates coupled with the 3.8 percent Medicare tax pose new tax threats that demand closer analysis and proactive management to minimize potential income tax consequences.

Mitigating income taxes

Outright distribution. Some have contemplated an outright distribution directly to the surviving spouse. On the first spouse's death, the assets would receive a step-up in basis, and on the surviving spouse's death, the assets would receive a second step-up, thereby avoiding the income tax threat. The advantage of this solution is its simplicity. The disadvantages include:

- portability of the deceased spouse's unused applicable exclusion amount may terminate if the surviving spouse remarries, because portability is only available for the last decedent spouse;
- an outright distribution is inappropriate for an elderly, frail, easily influenced surviving spouse;
- assets left outright and free of trust are subject to the survivor's creditors and would pass according to the surviving spouse's estate plan, which may be inconsistent with the predeceased spouse's intentions;
- portability is fixed at $5 million and is not adjusted for inflation. If the decedent's taxable estate plus the survivor's exceeds $10.34 million in 2014 ($5 million portability plus $5.34 million exemption), the excess over the exemption is taxed at a maximum tax rate of 40 percent at the federal level; and
- additional estate taxes may be imposed at the state level, since portability is not available.

Fully fund the marital deduction trust. Another option is to include a formula that fully funds the marital deduction trust. Upon the first spouse's death, all assets would be allocated to a marital deduction trust.

This option is advantageous in that it secures a basis adjustment to the fair market value at the survivor's death. If the combined estates of David and Diane are less than the estate tax exemption at the state level ($4 million for Illinois residents) and are not expected to increase, this is a viable tax option. The fully funded marital deduction trust could include the option allowing the surviving spouse to disclaim her interest in that trust, forcing the allocation to the traditional credit shelter trust.[24] See Figure 3.

Often in first marriages, a surviving

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18. 26 U.S.C. § 2011(b)(1) (2013); 35 ILCS 405/2(b) (2013). At the time of publication, the 2014 Illinois estate tax calculation was not yet made available.

19. 35 ILCS 405/2(b-1) (2013).

20. *See* Illinois Attorney General, *2013 Decedent Estate Tax Calculator*, http://illinoisattorneygeneral.gov/publications/calculator/2013calc/calculator2013.html (accessed June 4, 2013).

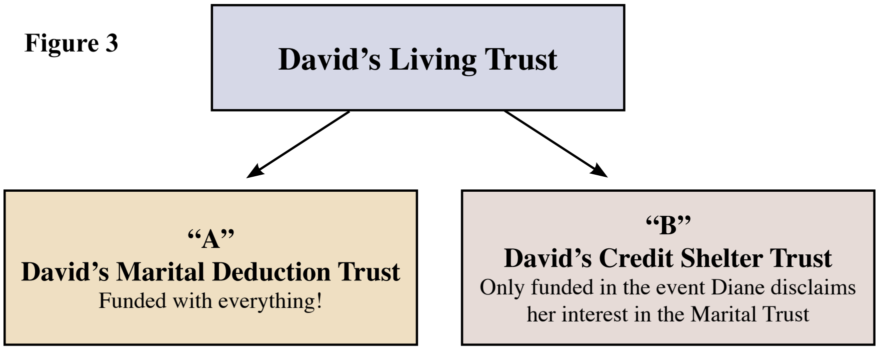
21. *See* Bruce Steiner, *The General Power of Appointment Trust is Back,* 2060 LISI Estate Planning Newsletter (2013).

22. 35 ILCS 5/201 (2013).

23. Robert Avery, Daniel Grodzicki & Kevin Moore, *Estate vs. Capital Gains Taxation: An Evaluation of Prospective Policies for Taxing Wealth at the Time of Death*, The Federal Reserve Board (April 2013), *available at* http://www.c.federalreserve.gov/pubs/feds/2013/201328/201328pap.pdf.

24. 26 U.S.C. § 2518 (2013); Rev. Proc. 2001-38 I.R.B.

Figure 3



spouse will be given a limited power of appointment to allocate the credit shelter trust among the descendants of the grantor. This power is forfeited if the surviving spouse disclaims her marital deduction trust to a credit shelter trust.[25] This is because a disclaimed interest must pass without any direction by the disclaimant.[26] Thus, a disclaimer of the marital deduction trust fixes the allocation to the next generation based on the predecessor spouse's credit shelter trust.

The primary caution with this planning technique is that it can be hard to predict with certainty that the combined gross estates will be valued less than the federal estate or state estate tax exemptions. For young couples whose future earnings are unknown, this may not be the appropriate plan. However, for a couple nearing retirement with relatively fixed asset values, this may be an appropriate tax fit.

There are many other cautions associated with fully funding the marital deduction trust, including the following:

- a potential federal estate tax is exposed for clients with assets in excess of the federal exemption of $5 million, indexed for inflation;
- a potential state estate tax is exposed for clients who reside in states that have decoupled from the federal legislation – which could be a surprisingly large tax;
- it abandons the predeceased spouse's GST exemption;
- the IRS Code requires the marital deduction trust must be solely for the benefit of the surviving spouse (descendants cannot be beneficiaries);
- if there is a depressed period like 2008 and 2009 upon the survivor's death, the fair market value could produce a "step down" in basis, creating income tax liabilities when later sold;[27]
- if disclaimer is a choice, the election must be made within nine months of the predecessor's death, which may be too soon to make a thorough evaluation;[28]
- the IRS Code requires the income to be distributed to the surviving spouse, which means the creditors of a surviving spouse might reach the income; and
- some survivors may simply not like the provisions in the credit shelter trust and refuse to disclaim in spite of the tax issues.

A better solution

To allow for increased flexibility, adding specific language to the traditional A/B trust to address the income tax concerns related to appreciated assets may be the best fit.[29] While this structure is more complicated than a simple outright distribution to a surviving spouse or to fully fund a marital deduction trust, the advantages are as follows:

- it preserves the federal estate tax exemption upon the first spouse's death;
- it preserves the state estate tax exemption upon the first spouse's death;
- it preserves the GST exemption amount upon the first spouse's death;
- the credit shelter trust offers asset protection for the surviving spouse and descendants, since distributions are often discretionary;
- it allows for a spray provision to descendants, heirs, charities, etc.;
- it preserves the potential for a double step-up in basis without running the risk of a step-down in basis; and
- it provides greater flexibility in allowing the surviving spouse to allocate assets in the credit shelter trust.[30]

A/B trust: Avoiding capital gains/ Medicare tax

To avoid the potential capital gains, Medicare, and state income tax in the credit shelter trust, a step-up in basis at the survivor's death is required. There could be substantial appreciation in the assets of the credit shelter trust between the date of the death of the first spouse and the surviving spouse.

Code Section 1014(a) provides that a decedent has a basis adjustment to fair market value at death. It states: "The basis of property in the hands of a person acquiring the property from a decedent…shall, if not sold, exchanged, or otherwise disposed of, be…the fair market value of the property at the date of the decedent's death…."[31]

The challenge: how can we transmute the fair market value at the date of death of the first spouse to the fair market value at the date of death of the surviving spouse? And how, in a depressed economy, can we avoid a potential step down in basis at the surviving spouse's death? We want to enable our clients to get a double step-up in basis (but not a step-down) and at the same time minimize any potential federal or state estate tax consequences.

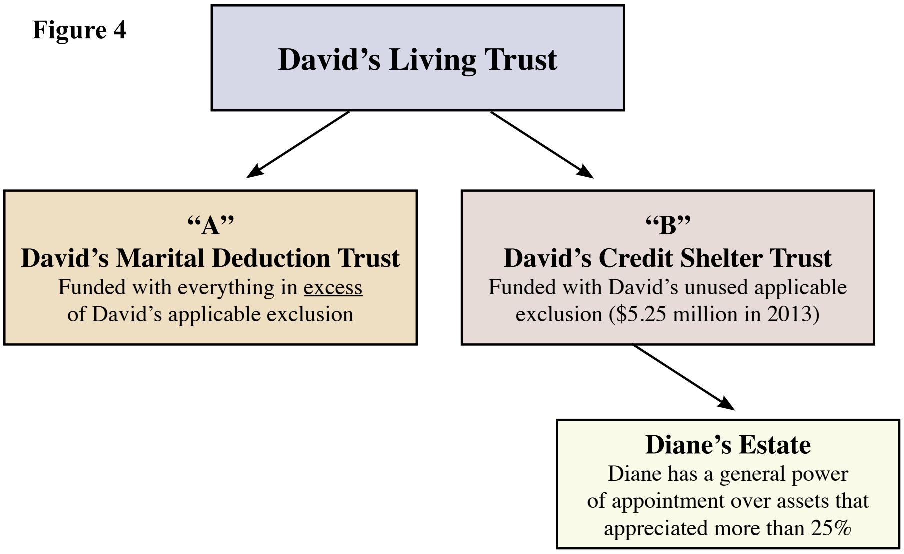
General power of appointment. A solution to this dilemma may be to give a special trustee (an independent, non-adverse trustee or protector) the power to grant the surviving spouse a general power of appointment over particular assets. If we do, Code Section 2041(a)(2) states those assets are included in the survivor's estate. If the assets are included in the surviving spouse's estate, a basis adjustment is realized.[32]

Under Code Section 2041(b)(1), "the term 'general power of appointment' means a power which is exercisable in favor of the decedent, his estate, his creditors or the creditors of his estate…."[33] Thus, consider using the following credit shelter trust provisions.

- First, in the credit shelter trust of the predecessor spouse, the special trustee/protector is given the option to

25. 26 U.S.C. § 2518(b)(4) (2013).
26. *See* Christopher P. Cline, *Disclaimers—Federal Estate, Gift and Generation-Skipping Tax Considerations*, 848-2nd Tax Mgmt. (BNA) Estates, Gifts, and Trusts, at A-19 (2012).
27. 26 U.S.C. § 1014(a) (2013).
28. 26 U.S.C. § 2518(b)(2) (2013).
29. *See* Ed Morrow, *Ed Morrow & The Optimal Basis Increase Trust*, 2080 LISI Estate Planning Newsletter (2013).
30. Specifically, the surviving spouse retains a limited power to allocate assets among descendants, heirs, and charities in the surviving spouse's discretion. Things change between the passing of the spouses. It may be appropriate to allocate more assets to a disabled grandchild or a child with limited means, and perhaps less to a child who has had substance abuse problems. The predeceased spouse could not know this.
31. 26 U.S.C. § 1014(a) (2013).
32. 26 U.S.C. §§ 1014(a), 1014(b)(9) (2013); *see also* Howard M. Zaritsky, *Revocable Inter Vivos Trust*, 860 Tax Mgmt. (BNA) Estates, Gifts, and Trusts, at A-63 (2010) (discussing the applicability of 1014(e) to certain joint trusts).
33. 26 U.S.C. § 2041(b)(1) (2013).

Figure 4



grant the survivor a testamentary general power of appointment exercisable by will in favor of the "creditors of the survivor's estate." This is a very narrow definition, but all that is necessary to activate the general power.

• Second, limit the general power of appointment pro rata over property with a basis less than a particular level – for example, the power of appointment only applies to assets valued at less than 75 percent of fair market value at the survivor's date of death.

Can we so limit the power? IRS regulation 20.2041-1(b)(3) states as follows: "If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, Section 2041 applies only to such part or interest."[34]

Thus, the general power only applies to property that has a fair market value exceeding its basis by 25 percent or more as of the date of the survivor's death. So, David's trust would be structured as a traditional A/B trust. A special trustee would have the option to grant Diane a general power of appointment over assets in the credit shelter trust that appreciated more than 25 percent. This would cause those assets to be included in Diane's estate and receive a step-up in basis. See Figure 4.

With respect to state tax where a QTIP provision is permissible in the credit shelter trust, the general power could apply only to the portion of the trust that makes the state QTIP election. Recall that the QTIP property remains subject to state estate taxes to the survivor with or without the general power. If the potential gain was significant, however, the general power could also apply to the non-QTIP portion.

To assure the amount subject to the power does not trigger federal estate tax to the survivor, the trust could provide that the power is not applicable, nor exercisable, nor effective in excess of the surviving spouse's applicable exclusion amount.

In addition, because the special trustee has the option to grant the surviving spouse the general power, we can avoid issues related to whether the surviving spouse should disclaim her testamentary power of appointment.[35] A testamentary power of appointment must be disclaimed within nine months of the date of creation of the power.[36]

Thus, if the surviving spouse was granted this power directly, arguably the spouse may have to disclaim within nine months after the predecessor spouse dies. She could, however, survive many years after the predecessor spouse. To provide more flexibility to the survivor, a special trustee may be empowered to grant the general power to the survivor.

Sample language. To achieve a step-up in basis for appreciated property in the credit shelter trust, consider using the following language. Please note that for residents of jurisdictions that have not decoupled (or have decoupled but do not allow for a QTIP election at the state level), the language should be revised accordingly.

> Notwithstanding any provision inconsistent herewith, the special trustee is authorized and empowered in his or her absolute discretion at any time to grant the Grantor's spouse a testamentary general power to appoint to creditors of her estate by will the following property: property determined pro rata, in either the QTIP or non-QTIP portion of the Credit Shelter Trust, that has a tax basis of less than 75% of its finally determined fair market value at the date of death of Grantor's spouse. Provided, however, this general power to appoint shall not be applicable, nor effective, nor shall it be exercised over any property that causes the Grantor's spouse to exceed her federal or state applicable exclusion amount, nor in any manner that causes or increases federal or state estate taxes to the estate of Grantor's spouse.[37]

Conclusion

For clients with combined estates that are reasonably certain to remain under the federal and state exemptions, a fully funded marital deduction trust may be the appropriate fit. In other instances, it seems wise to continue with the traditional A/B trust format if clients are expected to have combined net worth in excess of a certain amount that threatens federal or state estate taxes.

However, as the foregoing examination reveals, the "bad" and "ugly" provisions of the new law demand greater attention to income tax considerations than in the past. To avoid increased income tax while preserving the A/B trust structure, it may be best to add language to the credit shelter trust allowing a special trustee/protector the power to grant the surviving spouse a general power of appointment over trust assets that appreciate by more than 25 percent. ■

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34. 26 C.F.R. § 20.2041–1(b)(3) (2013); *see also* I.R.S. Priv. Ltr. Rul. 200403094 (Jan. 16, 2004).

35. 26 C.F.R. § 25.2518-2(c)(3) (2013) (providing that "[w]ith respect to transfers made by a decedent at death, or transfers that become irrevocable at death, the transfer creating the interest occurs on the date of the decedent's death"); 26 C.F.R. § 20.2041-3(d)(6) (2013) (providing that "[a] disclaimer or renunciation of a general power of appointment…is not considered to be the release of the power if the disclaimer or renunciation is a qualified disclaimer"); *see also* 755 ILCS 5/2-7 (2013).

36. 26 C.F.R. § 25.2518-2(c)(3) (2013) (stating that "…in the case of a general power of appointment, the holder of the power has a 9 month period after the creation of the power in which to disclaim"); *see also* Christopher P. Cline, *Disclaimers – Federal Estate, Gift and Generation-Skipping Tax Considerations,* 848-2nd Tax Mgmt. (BNA) Estates, Gifts, and Trusts, at A-11 (2012); Christopher P. Cline, *Powers of Appointment – Estate, Gift, and Income Tax Considerations*, 825-3rd Tax Mgmt. (BNA) Estates, Gifts, and Trusts, at A-37 (2012).

37. Turney P. Berry and Paul S. Lee posit that in CA, NY, and other high income tax states, it may be beneficial to achieve the step-up in basis and avoid paying more expensive capital gains, Medicare, and state income tax, even if it means paying a Federal estate tax. Specifically, even for a $20 million estate, it may be less expensive to pay Federal estate taxes than state income tax, capital gains tax, and Medicare tax. Turney P. Berry & Paul S. Lee, *Retaining, Obtaining, and Sustaining Basis*, Ch.6, Thirty Ninth Annual Notre Dame Tax & Estate Planning Institute, South Bend, IN, Oct. 17, 2013.