Estate Planning 2014: Key Points from the 2014 Heckerling Institute on Estate Planning

Introduction
Estate planners, including attorneys, trust officers, accountants, insurance advisors, and wealth management professionals, gathered recently for the 48th Annual Heckerling Institute on Estate Planning.1 Martyn Babitz, Hawthorn’s National Director of Estate Planning and author of this report, attended the week-long conference, which featured lectures and breakout sessions on the latest estate planning techniques and strategies. In this report, he summarizes his thoughts and what he gleaned from the speakers’ remarks on several estate planning topics. We hope you find this report helpful as you discuss your estate planning needs with your tax, legal, accounting, and wealth management advisors.

Strategic Planning for Families
A major theme unfolded during the presentations, one that focused on substantially higher, inflation-indexed estate tax exclusions, higher capital gains rates, portability of exclusions, and related new flexibility in federal gift tax and estate tax laws. That is, removing assets from one’s taxable estate at the cost of a loss of stepped-up basis may no longer be an appropriate trade-off in every estate plan, even for ultra-affluent individuals and families. Rather, preservation and creation of basis should receive more attention as a key objective in planning.

In fact, we believe the importance of overall strategic planning for families transcends tax-focused planning more than ever. The key role of an estate planning advisor seems to be emerging – that is, to help keep wealthy families wealthy. In this regard, estate planning and strategic decisions have been made far more complex by the narrowed gap between death taxes and capital gains taxes, the impact of state of residence on this gap, the uncertainty of inflation in affecting the size of the estate tax exclusion, as well as newly available tools such as exclusion portability.

The bottom line is that many more variables must now be considered in estate planning decisions, making one-size-fits-all approaches to planning unacceptable in the current environment, in our opinion.

1The 48th Annual Heckerling Institute on Estate Planning was held on January 13–17, 2014, in Orlando, Florida. More information on sessions and speakers can be found at http://www.law.miami.edu/heckerling/
New Focus on Income Tax Issues in Estate Planning

Gifting assets can remove those assets, and their subsequent predeath appreciation, from the transferor’s taxable estate for federal estate tax (and state death tax) purposes. These death taxes are thus avoided as to the entire value of the asset at death. The trade-off, however, is that an asset not included in a decedent’s taxable estate will not generally obtain an increase (or “step-up”) in basis to its fair market value at the time of death, thus forfeiting the opportunity to reduce capital gains taxation on the sale of the asset by the decedent’s heirs. Although the capital gains tax would apply only to a portion of the value of the asset equaling the difference between the decedent’s cost basis in the asset and its fair market value at his or her death, this can be quite significant, particularly in the current tax environment.

A presentation by Paul S. Lee of Bernstein Global Wealth Management focused on the increased importance of analyzing this trade-off in light of the substantial tax changes made by the American Taxpayer Relief Act of 2013 (ATRA) for 2014 and beyond.

In the highest federal income tax brackets (for 2014, over $457,600 for married couples filing jointly and over $406,750 for single taxpayers), the long-term capital gains tax rate is now 20%. For high income taxpayers (over $250,000 for married couples filing jointly and over $200,000 for single taxpayers), the new 3.8% Medicare surtax on net investment income is also applicable. In addition, a federal estate tax rate of 40% generally applies to assets over the exclusion amount ($5.34 million per person in 2014, indexed for inflation).

Also, the income tax and death tax laws and rates in various states generally affect the trade-off between estate exclusion and income tax basis in planning, as demonstrated in Table 1.

Table 1
Trade-off Between Estate Exclusion and Income Tax Basis

<table>
<thead>
<tr>
<th></th>
<th>Capital Gains Tax Rates</th>
<th>Estate/Death Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>State</td>
<td>Federal*</td>
</tr>
<tr>
<td>Washington</td>
<td>–</td>
<td>23.8%</td>
</tr>
<tr>
<td>Florida</td>
<td>–</td>
<td>23.8%</td>
</tr>
<tr>
<td>New York City</td>
<td>12.67%</td>
<td>23.8%</td>
</tr>
<tr>
<td>California</td>
<td>13.3%</td>
<td>23.8%</td>
</tr>
</tbody>
</table>

*Federal long-term capital gain rate of 20% plus 3.8% Medicare tax
**Includes state death tax deduction under IRC Section 2058

Table 1 suggests to us that certain existing estate planning maxims may no longer be applicable or appropriate in many situations. For example, using one’s lifetime gift and estate tax exclusion ($5.34 million, indexed for inflation) during one’s lifetime at the cost of losing the step-up in basis at death on the gifted assets for capital gain tax purposes may not be advisable in many situations.

Also, transfers to multigenerational trusts that are excluded from the taxable estates of descendents in all cases, thus losing the opportunity to obtain a step-up in basis at their deaths, may not always be ideal, in our opinion. In
addition, the need to focus on state of residence in planning has been amplified. We believe it is no longer a safe approach to view income tax as far less important than death tax in estate planning.

**Portability, Indexed Exclusion, and Wealth Transfer without Using Exclusion**

Beyond the narrowed gap between death tax and capital gains rates, even high net worth taxpayers must take into account additional factors that suggest against using lifetime gift tax exclusions and transferring appreciating assets out of one’s taxable estate as soon as possible.

**Indexing for Inflation**

Indexing for inflation of the lifetime gift tax and estate tax exclusion may be significant, particularly if the inflation rate, as expected, increases in the future (Table 2).

**Table 2**

**Federal Estate Tax Exclusion over 25 Years at Various Inflation Rates**

<table>
<thead>
<tr>
<th>2014 Exclusion Amount</th>
<th>Inflation Rate</th>
<th>2039 Exclusion Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,340,000</td>
<td>2.0%</td>
<td>$8,760,837</td>
</tr>
<tr>
<td>5,340,000</td>
<td>3.5</td>
<td>12,619,732</td>
</tr>
<tr>
<td>5,340,000</td>
<td>5.0</td>
<td>18,083,141</td>
</tr>
</tbody>
</table>

Source: Hawthorn/Keith Brabec

In our view, indexing must be reviewed against the projected growth or diminution of an individual’s or couple’s taxable estate over their life expectancy. Lifestyle expenditures, asset allocation, and expected investment growth should be taken into account when determining whether aggressive gifting, with corresponding loss of stepped-up basis at death, is advisable.

**Portability**

Portability now permits a surviving spouse to utilize the estate tax exclusion of the first spouse to die at the survivor’s death, ensuring that the first spouse’s exclusion will not be “wasted.” Formerly, a separate credit shelter trust was typically created to allow for use of the first spouse’s exclusion while permitting the survivor to benefit from the assets as needed for the balance of his or her lifetime. These assets can now instead pass to the survivor outright, and he or she can apply the first spouse’s exclusion at the death of the second spouse while such assets benefit from a stepped-up basis upon the survivor’s death.

Another option afforded by portability for higher net worth couples is the opportunity for the surviving spouse to create a credit shelter trust that is a grantor trust for income tax purposes. That is, following the death of the first spouse, the survivor can utilize the decedent spouse’s unused exclusion (known as the Deceased Spousal Unused Exclusion, or DSUE) to create an irrevocable grantor trust. This approach would allow the survivor to continue to be taxed on the income of that trust, thereby amplifying the growth of those assets unencumbered by income taxation and further reducing the survivor’s estate by the income tax liability paid on behalf of the trust. Thus, the trust remainders, typically descendants, enjoy pretax return on the trust assets for their ultimate
benefit. This option is not available if a traditional credit shelter trust is established under the first spouse’s estate plan.

**Wealth Transfer**

Perhaps most importantly for high net worth individuals, substantial wealth transfer can be accomplished without using the lifetime gift tax exclusion. For example, zeroed-out Grantor Retained Annuity Trusts (GRATs) or sales, rather than gifts, of assets to family members (or trusts for their benefit) can allow for substantial wealth transfer while preserving the full estate tax exclusion amount for use against assets in the taxable estate to maximize the benefit of stepped-up basis. (For a detailed discussion of Zeroed-out GRATs and sales of assets to family trusts, see the June 2013 Hawthorn White Paper, *The Family Opportunity Trust, Part II: Leveraging the Trust.*)

**Asset Selection in Wealth Transfer**

Also significant in our view is the importance of asset selection in lifetime gifting decisions. Formerly, an estate planning advisor might reflexively choose highly appreciated assets for gifting, anticipating additional rapid growth of such gifted assets outside the taxable estate of the client. Such assets now may not always be the preferred choice for gifting depending upon the client’s overall net worth, state of residence, and other available assets.

Instead, gifting assets that have little or no built-in gain may be more suitable candidates. Examples would include cash (where basis equals value), fixed income assets such as bonds with minimal built-in gain, or equities with a current built-in loss. Also, certain assets are now more critically important to preserve in one’s taxable estate for basis step-up at death. Such assets include artwork, collectibles and gold (which are taxed at 28% rather than 20% long-term capital gains rates), and long-held depreciated real estate assets which may have a negative basis that will be ultimately recaptured upon sale.

**Additional Complexity in Decoupled States**

Several states, such as New York and New Jersey, have state estate taxes with a lower exemption than the federal estate tax exclusion and do not allow for portability of the exemption. For example, New Jersey retained the $675,000 exemption for its estate tax that was in effect for federal estate tax purposes in 2001, even though the federal estate tax exclusion increased to $1 million in 2002 and continued to increase in subsequent years. That is, New Jersey, and several other states, "decoupled" from the federal estate tax for estate tax exemption purposes.

In decoupled states, it might seem advisable to establish a state exemption shelter trust for a surviving spouse rather than leave all assets directly to him or her in order to preserve the state exemption of the first to die. Portability can then be utilized at the federal estate tax level with respect to the additional amount of the federal exclusion over the state exemption amount.

With a top state estate tax rate of 16% (New Jersey) in decoupled states, however, one must consider whether avoiding the 16% or lower state estate tax rate is justified in exchange for losing a stepped-up basis that may save 23.8% or more of capital gains taxation. Bear in mind that in these states, an additional state income tax often applies, considerably driving up the capital gains tax savings resulting from a state-level step-up in basis due to inclusion of the asset in the decedent’s estate for state death tax purposes. For example, in New Jersey,
with a top state estate tax rate of 16% and a top income tax rate of 8.97%, the potential combined federal and state capital gains tax savings for incurring the 16% New Jersey estate tax liability at the first death in order to accomplish a stepped-up basis could be as much as 32.77%, or 16.77% greater than the state estate tax liability. (This example is from the presentation “Venn Diagrams: Meet Me at the Intersection of Estate and Income Tax,” Heckerling Institute on Estate Planning, Paul S. Lee, Bernstein Global Wealth Management.)

Of course, if a couple lives in a decoupled state and the ultimate beneficiaries (for example, their children) live in another state with lower or higher state income tax rates, the decision on whether to establish a credit shelter trust for the state exemption is further complicated and we believe requires stringent quantitative analysis.

Generation-Skipping and Dynasty Trusts in the New Tax Environment

The Generation Skipping Transfer Tax (GST) exemption (also $5.34 million per person in 2014, indexed for inflation) generally allows for transfers to “skip persons” (generally beneficiaries two or more generations removed from the transferor, such as grandchildren) or trusts for them to escape estate taxation not only at the level of the transferor but also at the level of his or her children. By using trusts to which the GST exemption is applied, known as GST-exempt trusts, the exclusion of transferred assets and their growth can generally be excluded from the taxable estates of grandchildren and many subsequent generations as well. These trusts are sometimes referred to as dynasty trusts.

Traditionally, estate planning advisors for high net worth families have typically aimed to use, not “waste,” the GST exemption. Capital gains rates are higher, and inflation-adjusted estate tax exclusions for subsequent generations may be dramatically higher than current levels. Accordingly, we believe excluding assets from descendants’ estates may be inadvisable in some cases. Rather, we view including some of these assets in their estates to obtain a stepped-up basis as preferable, particularly as the number of beneficiaries (and exemptions) increases and the size of their average taxable estates decreases.

As a hypothetical example, assume a married couple with a net worth of $15 million and two children. The couple utilizes their combined $10.68 million estate tax exclusions and GST exemptions. In so doing, they establish a dynasty trust in the amount of these exemptions in their wills. They both die in 2014. With $10.68 million of stepped-up basis assets, assume the trust grows 8% annually, net of any distributions to beneficiaries. The couple’s two children have three children each, and those six grandchildren produce 16 great-grandchildren. These 24 total beneficiaries have a total of $128.16 million of estate tax exclusions, which could be $256.32 million if spouses are counted as well. In addition, these estate tax exclusions will be indexed up for inflation over time. With each generation, there will be more individuals. In addition, the likelihood increases that some of them will have taxable estates less than their estate tax exclusion amount. This is because they are perhaps relying on the dynasty trust for support or are not achieving the same level of financial success as their predecessors. Thus, in this example the opportunity to utilize these untapped exclusions to accomplish stepped-up basis as to some of the assets of the dynasty trust would be wasted in a traditional trust of this type.

Consequently, a challenge for such long-term family trusts is to create basis for income tax purposes while avoiding the payment of death tax. Under the trust
laws of states such as Delaware, a typical dynasty trust could allow for a trust protector to give testamentary general powers of appointment to these beneficiaries to the extent of their unused estate tax exclusions. Assets up to this amount would thereby be included in their taxable estates and achieve a stepped-up basis. To the extent the general power were not exercised, assets in this amount could remain in the trust and the instrument could allow the trustee to allocate this amount to the assets that would most benefit from a step-up in basis.

Along these lines, another possibility for basis creation runs counter to traditional estate planning—“upstream” transfers of assets to a generation above the transferor (for example, parents) who have available estate tax exclusion. Such transfers would typically make sense through zero exclusion transfer strategies, which could include annual exclusion gifts (currently $14,000 per year per donee without requiring the use of lifetime gift and estate tax exclusion) or zeroed-out GRATs. At the parent’s death, these assets would transfer back to lower generations with a stepped-up basis and be protected from estate taxation by the parent’s remaining estate tax exclusion. Such assets could not pass back to the original transferor or transferor’s spouse within a year of the original gift to the parent in order to avoid invalidating the basis step-up under Section 1014(e) of the Internal Revenue Code. Similarly, parents could be potential beneficiaries of a dynasty trust, and a trust protector could have the power to give a general power of appointment to the parent to the extent of his or her remaining estate tax exclusion in order to provide for estate inclusion of that amount in the parent’s estate and corresponding basis step-up.

Income Shifting
With a top 43.4% tax rate and a new top capital gains rate of 23.8%, when factoring in the 3.8% Medicare tax on net investment income, and trusts subject to these brackets at just $11,950 of income, considering strategies to manage the taxability of income from family wealth takes on greater importance. This importance is amplified by the potential disparity of state income tax rates among family members based on their residence as well as the availability of lower ordinary income and capital gains tax brackets for taxpayers at lower levels of income and gains. Paul Lee’s presentation at the 2014 Heckerling Institute on Estate Planning reviewed options for shifting income and corresponding tax liability to effectively deal with these factors.

Among simpler approaches, in our view, would be considering more discretionary distributions of income to family trust beneficiaries, particularly those with lower amounts of other income or those in low (or no) income tax states, if doing so would not conflict with another, more fundamental purpose of the trust. Although long-term family trusts, such as the dynasty trusts, are often designed to be outside the taxable estates of the beneficiaries, and thus a traditional objective is to accumulate income in the trust to enhance this benefit, income tax consequences must be carefully considered in the context of total family wealth accumulation and preservation. Typically, such a trust may be structured as a grantor trust for income tax purposes, thus passing the trust’s income tax liability to the grantor and, at the grantor’s death, such status terminates and the trust will be subject to taxation on accumulated income (at the highest rates on income over $11,950). In many cases, distributing income to beneficiaries to take advantage of potentially lower marginal brackets can be advisable, particularly if such beneficiaries have available estate tax exclusion to shield such distributions and the growth of the distributed assets inside the beneficiaries’ estates from ultimate estate taxation, while correspondingly allowing such assets to obtain a stepped-up basis at their deaths.
Using their available estate tax exclusions, such beneficiaries could re-transfer the distributions to the family trust or a newly created trust at their deaths.

Other income-splitting possibilities include partnerships or S corporations, where income can be passed through to equity interest holders without making distributions. With partnerships, it may be possible to provide for disproportionate allocations of income by utilizing preferred interests. Care must be taken to avoid having such interests within a family partnership valued at zero under Section 2701 of the Internal Revenue Code through the exceptions therein.

**Charitable Remainder Trusts**

Charitable Remainder Trusts (CRTs) are trusts paying a fixed annuity or fixed percentage of assets annually to one or more beneficiaries for a period of years or the lifetime(s) of the grantor or beneficiaries. Because the trust itself is tax exempt, a transfer of a highly appreciated asset to a CRT typically avoids immediate capital gains taxation when sold by the CRT. The gain is generally recognized by the beneficiary since distributions are made to him or her. Accordingly, a taxpayer who would otherwise be subject to the highest 23.8% capital gains tax rate on the disposition of a highly appreciated asset, such as a concentrated position in a stock, could nevertheless dispose of such asset, obtaining the benefit of diversification in the case of a concentrated position, as well as a guaranteed cash flow, without immediate taxation. The distributions from the CRT each year may be taxed below the top rate if these proportionate, smaller annual distributions do not push the beneficiary or beneficiaries into the top brackets for capital gains and the 3.8% Medicare surtax. In addition, if the original transferor of the asset to the CRT is the beneficiary but moves from a high income tax state to a low (or no) income tax state, significant additional benefits may be derived. In addition, if one or more of the CRT beneficiaries are lower bracket taxpayers than the original transferor, or if multiple beneficiaries are utilized to spread the distributions carrying out capital gains, substantial income tax savings may result.

**Qualified Personal Residence Trusts**

A Qualified Personal Residence Trust (QPRT) is a trust to which a primary or secondary residence is contributed, with the transferor retaining the right to continue to live in the home for a period of years. This retained right reduces the value of the gift of the remainder interest in the home, thus allowing for a gift of the residence, plus its appreciation, at a fraction of its actual value. If the grantor survives the term of his or her retained interest, the home will be outside of his or her taxable estate but it will not obtain a step-up in basis upon the transferor’s death.

With higher estate tax exclusions and higher capital gains rates, a QPRT may no longer be a tax-efficient vehicle in some cases. There may be options for favorably addressing this issue.

For example, at the end of the retained term of years, the grantor could continue to live in the home without paying fair rental to the remaindermen (typically the grantor’s children or a trust for them). This would constitute a retained interest that would cause the home to be included in the grantor’s taxable estate under Section 2036 of the Internal Revenue Code. (This scenario derives from a written summary by Martin M. Shenkm an, a presenter at the Heckerling Institute.) Alternatively, during the retained term, the grantor might purchase the home from the trust with cash (for which tax basis is not an issue), converting the QPRT to a
Qualified Annuity Trust paying him or her a pro-rated annuity for the balance of the retained term of years.

**Delaware Incomplete Non-Grantor Trusts**

For taxpayers in high income tax states such as California, New Jersey, and New York, Delaware trust law (and the laws of a few other states) offers the possibility of establishing a non-grantor trust wherein accumulated income will not be subject to income tax in the grantor’s home state nor in Delaware. The transfer of assets to such a trust is not considered a taxable gift; accordingly, the assets will be included in the transferor’s taxable estate and obtain a step-up in basis at death, according to Richard W. Nenno during his presentation “There’s No Place Like Home, But Where’s Home? The Role of ‘Residence’ and ‘Domicile’ in State Income and Transfer Tax Planning.”

The above type of trust is known as a Delaware Incomplete Non-Grantor Trust, or DING. The grantor can receive distributions from such a trust, and the assets therein are protected from creditors’ claims under Delaware’s asset protection laws for appropriately structured self-settled trusts. (See the June 2013 Hawthorn White Paper, *The Family Opportunity Trust, Part II: Leveraging the Trust*, p. 7.)

**Reversing Valuation Discounts**

Some family entities such as Family Limited Partnerships (FLPs) may have been established in prior years when the importance of taking valuation discounts for the lack of marketability and control inherent in the minority interests was significant for wealth transfer purposes in light of lower lifetime gift and estate tax exclusion amounts and higher estate tax rates. This may no longer be as important in some situations.

In such cases, stepped-up basis on the full value of the assets within the FLP may have become more important. In such circumstances, the entity could perhaps be dissolved and the assets distributed to the interest holders. Alternatively, the FLP agreement might be amended to permit partners to withdraw or liquidate their interests (which would also seemingly have the effect of significantly reducing or eliminating the valuation discount as to the limited partnership interests of those partners remaining in the partnership). (Paul S. Lee, Bernstein Global Wealth Management, discussed this in depth during his presentation “Venn Diagrams: Meet Me at the Intersection of Estate and Income Tax.”)

**Roth IRA Conversions**

There is no longer an income eligibility cap on converting existing IRA accounts in whole or part to a Roth IRA. Although income tax is paid immediately on the amount of the conversion, future growth and qualified distributions are entirely income-tax-free. In addition, a Roth IRA owner need not take any distributions during his or her lifetime. On the other hand, required minimum distributions from traditional IRAs are required after the owner attains age 70-1/2. Accordingly, a Roth IRA typically allows for additional income-tax-free growth of the assets for the designated beneficiary who can take distribution on a tax-free basis over his or her life expectancy.

It may be advisable to consider partial Roth conversions each year to the extent that they do not push overall income into the highest brackets that would subject other net investment income to the 3.8% Medicare surtax or the top income tax brackets. Christopher R. Hoyt expressed this sentiment during his presentation “Health Care Surtax: Individuals – Dancing Under a 3.8% Limbo Pole.”
Conclusion

A clear theme emerging from the Heckerling Institute on Estate Planning, in our opinion, is that the new federal and state tax environment has significantly shifted the priorities in tax-oriented estate planning. No longer can estate planning advisors focus primarily or exclusively on the death tax mitigation aspects of planning strategies and structures. Income tax planning and basis preservation strategies have become more important. This planning dimension makes estate planning decisions more complex and requires greater attention to detail as to tax brackets, state of residence, and net worth of all family members in all generations.

The new “permanence” of the estate tax rate and exemption has provided some clarity going forward. Nevertheless, we believe that inflation indexing and portability of the exclusion, as well as significantly higher income tax and capital gains rates, fueled in part by the new 3.8% Medicare surtax on net investment income, have confounded the corresponding estate planning simplicity that may have been anticipated by the recent estate tax reform.

The author gratefully acknowledges the substantial contributions of Keith R. Brabec, Wealth Strategist, and Michael Monroe, Senior Wealth Strategist.
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