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A report for clients and friends of the firm.

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With over a century of combined experience, the lawyers of Proskauer’s Personal Planning Department regularly provide their diverse clientele – from business entrepreneurs and corporate executives to sports figures and performing artists – with their Personal Planning Strategies Newsletter, a critical source of information which identifies significant issues of interest to Proskauer’s clients. The Personal Planning Strategies Newsletter provides articles addressing the latest statutory changes and developments affecting retirement, estate, insurance and tax planning, as well as cutting-edge corporate, real estate and tax concepts.

2014 Estate, Gift and GST Tax Update: What This Means for Your Current Will, Revocable Trust and Estate Plan

As we previously reported, the American Taxpayer Relief Act of 2012 (the “Act”) made the following permanent: (1) the reunification of the estate and gift tax regimes, (2) the $5 million estate, gift and generation-skipping transfer (“GST”) tax exemptions, as increased for inflation (as discussed below), and (3) portability.

Tax Exemption Inflation Increases for 2014

- In 2014, there is a $5,340,000 federal estate tax exemption (increased from $5,250,000 in 2013) and a 40% top federal estate tax rate.
- In 2014, there is a $5,340,000 GST tax exemption (increased from $5,250,000 in 2013) and a 40% top federal GST tax rate.
- In 2014, the lifetime gift tax exemption is $5,340,000 (increased from $5,250,000 in 2013) and a 40% top federal gift tax rate.
- In 2014, the annual gift tax exclusion is $14,000 (no increase from 2013).

These increased exemptions create opportunities to make larger lifetime gifts, to leverage more assets through a variety of estate planning techniques (such as a sale to a grantor trust) and to shift income producing assets to individuals such as children or grandchildren who may be in lower income tax brackets and/or reside in states with a low income tax rate or no state income tax.

Portability

With portability, a deceased spouse's unused estate and gift tax exemption is portable and can be used by the surviving spouse. Portability is intended to prevent families from incurring gift and estate tax that could have been avoided through proper estate planning. The following is an example of portability:

> Assume that Husband has $5 million of assets and Wife has $2 million of assets and that portability is not part of the law. Husband dies in 2012 leaving his entire $5 million to his Wife. Even though Husband has an estate of $5 million and a federal estate tax exemption of $5 million (for all purposes of this example, the exemption is not adjusted for inflation), his federal estate tax exemption is wasted because property passing to Wife qualifies for the unlimited federal estate tax marital deduction, and the marital deduction is applied before applying the federal estate tax exemption. Now suppose that Wife dies in 2014, the $5 million that she inherited from Husband had appreciated to $8 million, and her own $2 million remained the same value. Her total estate at her death is now $10 million. Applying her $5 million federal estate tax exemption, the remaining $5 million of her estate would be subject to federal estate tax at 40%, resulting in a tax of $2 million.
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> Now assume that portability applies upon Husband's death. Because Husband has $5 million of unused estate tax exemption, this can be passed to Wife for her use. Now, upon Wife's death in 2014, she has her own $5 million of federal estate tax exemption as well as the $5 million of federal estate tax exemption that she inherited from Husband, for a total federal estate tax exemption of $10 million. Since her estate is $10 million, her Estate can apply her entire $10 million federal estate tax exemption to insulate her entire estate from federal estate taxes. Thus, portability saves the heirs $2 million in federal estate taxes.

How do these changes affect your existing Proskauer estate planning documents?

Our estate planning documents are drafted to be flexible and, in general, their overall structure remains unaffected by the increased exemption amounts.

There may be instances where you will want to update your documents to reflect changes made by the Act, including the availability of portability. Additionally, if you are a married couple and live in a state with a state estate tax (mostly states in the northeast), there may be provisions that should be added to your documents which could save state estate taxes at the death of the first spouse.

Please do not hesitate to call us so that we can review your documents and make sure that they are up to date and reflect your current wishes.

One Year Later…

This time last year, we found ourselves in a whirlwind of advising clients to maximize transfer tax planning opportunities. We worked to ensure that clients took advantage of what many thought would be a once in a lifetime opportunity to transfer up to $5.12 million free from federal gift and generation-skipping transfer ("GST") taxes. Alas, by the time the dust settled on January 1, 2013, Congress was already hard at work passing the American Taxpayer Relief Act of 2012 ("ATRA"). ATRA made "permanent" the $5 million exemption equivalent amount for estate, gift, and GST tax purposes. This amount is adjusted for inflation in 2013 to $5.25 million and will increase to $5.34 million in 2014. Because of the 2012 dash to "use it or lose it," many clients used significant portions of their exemption in 2012 planning. So what have we been up to this year, and what do we expect for the year to come?

Cleaning Up Prior Planning

Now that there is some certainty in the transfer tax regime, one of the items we have focused on is "cleaning up" some of the lingering transactions from prior years.

Implementation and Reporting of Defined Value Gifts. Because of timing issues associated with obtaining appraisals and the desire to "hit the nail on the head" in making gifts exactly equal to the exemption amount, many clients implemented 2012 gifting through the use of "defined value" or "formula" clauses. These gifts were most commonly made of a client's interests in closely held entities, whether corporations, limited liability companies, or partnerships. This gifting technique was particularly attractive following the 2012 taxpayer victory in *Wandry v. Commissioner*, notwithstanding the IRS's later non-acquiescence. Although we carefully navigated *Wandry* and other defined value clause cases in advising clients with respect to these gifts, it is equally important to implement such gifts properly to ensure the benefits of the planning.

When documenting a specific number of shares of stock, partnership interests, or membership interests for transfer on the entity's books and records, the transfer should be caveated appropriately with a footnote or other cross-reference to the defined value or formula clause. Although it is likely acceptable to reflect a transfer of a specific interest on the entity's books and records, it must be crystal clear that the specific interest is derivative of the appraisal, and not of the finally determined value used for federal transfer tax purposes, which ultimately controls the specific interest that is transferred pursuant to the clause. Documenting this transfer as such is particularly important with respect to flow through entities (i.e., subchapter S corporations, partnerships, and limited liability companies) as, generally, distributions are made on a pro rata basis and taxable income is allocated on a pro rata basis.

In addition, when interests are transferred by or to trustees of irrevocable trusts, the trustees will have fiduciary obligations that must be satisfied with respect to such gifts. Translating the formula into a specific interest, even if using the appraised value as an estimate until there is a finally determined value, helps to satisfy the trustees' fiduciary obligations.

Clients Want to "Change" the Terms of the Trust. In the frenzy of signing and funding trusts prior to the end of 2012, many clients may not have had ample time to consider fully all the various provisions in quickly drafted trusts to which they made their 2012 gifts. For example, clients may want to consider different dispositive or fiduciary provisions than what were included in the instruments they signed. Indeed, if a trust was signed and funded toward the end of 2012, many clients may have used a "place holder" trustee to expedite the transaction. A simple "remove and replace" power in the trust instrument may permit flexibility in selecting a successor trustee. However, more significant changes may be in order. Relying on a decanting provision in the trust instrument or under state law can allow the trustee the flexibility to "change" the terms of the trust.

Depending on the terms of the trust instrument or provisions of state law, the "changes" to a trust that can be achieved through a trust decanting can be broad. Under many state statutes, the only changes that cannot be achieved through a trust decanting are the reduction or elimination of fixed income or annuity interests, the disqualification from a marital or charitable deduction, and the addition of trust beneficiaries. To the extent that the trust instrument and its governing law do not permit the trustees to decant the trust, the trustees should explore whether the governing law of the trust can be changed to a more favorable jurisdiction so that the decanting can be implemented. Additionally, clients might consider state statutes that provide for judicial or non-judicial modification or reformation. In so doing, trust beneficiaries must be sensitive to possible transfer tax consequences in the event consent (or even notice) is required.

Planning for Step-Up in Basis. Because of timing constraints and liquidity issues, many clients may have funded irrevocable trusts with low-basis assets. These clients would do well to consider the income tax consequences to the trust beneficiaries as a result of the loss of a step-up in basis at death. Two possible solutions are available for these clients.

First, if the trust contains a power of substitution, or "swap power" (many of the trusts that we drafted at the end of 2012 have these provisions), the client can "swap in" assets of equal value with a higher basis and "swap out" the low-basis assets. In executing this "swap," the trustees must ensure that the assets "swapped in" are equal in value to the assets "swapped out." Not only is this part and parcel to the trustees' fiduciary obligations, it is also necessary to avoid the imputation of any deemed gifts. The best practice is to disclose such "swaps" on a gift tax return.

Second, even if the trust does not contain a "swap power," but is otherwise a grantor trust, the client can purchase assets from the trust. The purchase can even be done with a promissory note. This allows the client to regain the economic benefits of the assets, while still having completed the gift and having an obligation at death that reduces the client's taxable estate. If, in making the gift, the client simply wanted to transfer an amount equal to the exemption, the note can be structured at the applicable federal rate to allow the client the benefit of any future appreciation. If the gift was intended to allow future appreciation to grow outside of the client's estate, then the note can be structured at a higher rate to result in greater appreciation within the trust.

Lack of GST Exemption. Most clients who used their entire exemption in 2012 gifting allocated GST tax exemption to those transfers. This may cause problems for clients who need to continue to rely on annual exclusion gifts to fund life insurance premiums through life insurance trusts. If the policy is owned by an "old and cold" life insurance trust, then funding such trust with annual exclusion gifts may result in a "mixed" GST tax inclusion ratio, as the client will no longer have GST exemption to allocate to the annual exclusion gifts. A "mixed inclusion ratio" means that a trust is partially GST exempt and partially GST non-exempt. Some relief may be available year-by-year because of the inflation adjustment of the exemption. For example, clients who maxed out their GST tax exemptions in 2012 have an additional $130,000 to allocate in 2013 and will have another $90,000 to allocate in 2014. This may go a long way for some clients in preserving the GST tax exempt status of their life insurance trusts.

However, if the additional exemption made available through the inflation adjustment is insufficient, alternatives need to be considered. The most attractive option is likely to make sure that the life insurance policy is owned by the same trust to which the 2012 gifting was made, so that the income from the gift, or a portion of the gift itself, may be used to service the premium payments, thereby preserving the GST tax exempt status of the trust. If the planning was not structured this way from the outset, several options may be available. First, the "old and cold" life insurance trust can be merged into the 2012 gifting trust under the terms of the trust instrument or under state law if such merger is so permitted. Second, the “old and cold” life insurance trust and the 2012 gifting trust can be decanted into a single new trust pursuant to the trust instrument or state decanting statutes. Third, if the prior two options are not available, the “old and cold” life insurance trust can sell the policy to the new trust. It is critical that the purchasing trust be treated as a grantor trust wholly owned by the insured in order to ensure that the transfer falls within the exception to the “transfer for value rules.”

Alternatively, clients can consider lending to life insurance trusts so that the trustees can use the loan proceeds to pay the life insurance premiums.

2012 Gifting Results in “Mixed Inclusion Ratios.” Because certain clients may have had more gift tax exemption than GST tax exemption remaining, they funded trusts in 2012 that resulted in mixed inclusion ratios. The solution to the tax inefficiencies caused by a mixed inclusion ratio is a qualified severance. A qualified severance is a severance of a trust with a mixed inclusion ratio into two or more separate trusts, so that one of the resulting trusts is wholly exempt and the other is wholly non-exempt. Generally, the severance must occur on a fractional basis and the terms of the new trusts, in the aggregate, must provide for the same succession of interests of beneficiaries as are provided in the original trust.

Reliance on the qualified severance provisions may be a huge relief for clients whose remaining exemption in 2012 exceeded their remaining GST tax exemption (most often on account of allocation to life insurance trusts or allocation upon the expiration of the annuity term of a GRAT). These clients wanted to max out the amount they could give in 2012 at the higher exemption, but had concerns about the long-term consequences of administering mixed inclusion ratio trusts. Thankfully, qualified severances are here to stay as a result of ATRA.

“Zero-Exemption” Planning

After the cleanup is done, there are still plenty of options for clients who exhausted their entire exemption through prior planning. The extra inflation adjustment may add just enough cushion for certain techniques as well.

Sales to Defective Grantor Trust. A sale to a defective grantor trust is the most logical and most powerful technique to implement as a follow-up to 2012 gifting. If the donor’s gifts were made to a defective grantor trust, then the “seed” required for a sale to the trust has already been planted. Assuming that the donor transferred $5.12 million to the trust and assuming a 10 percent seed consistent with the generally accepted rule of thumb, a donor could sell over $50 million of assets to a defective grantor trust. If the assets are closely-held business interests and the donor can substantiate a modest 25 percent valuation discount, the donor can sell almost $67 million of assets to the trust. So long as the Obama Administration’s proposal to kill defect grantor trusts does not become a reality, sales will remain very much en vogue.

Intrafamily Loans. An intrafamily loan is an often overlooked technique, perhaps given that it does not seem as “sexy” as other techniques. However, this technique should be at the top of most lists. By loaning assets to family members, or, better yet, defective grantor trusts, the spread between the return on investment of the loaned assets and the historically low applicable federal rate passes transfer tax free. It is simple, effective, and risk free. Best of all, intrafamily loans do not result in any taxable gift and, thus, no remaining exemption is required to implement the planning on a tax free basis.

Grantor Retained Annuity Trusts. GRATs remain attractive options for many clients, especially with historically low applicable federal rates. If structured as a "zeroed-out" GRAT, this may be one of the most effective planning techniques for clients who have little or no exemption remaining. Of course, the inability to allocate GST exemption during the GRAT term makes the planning somewhat less attractive. But many clients considering this as a "zero-gift" technique may have little or no GST exemption remaining anyway. Even if the 10 year minimum term as proposed by the Obama Administration becomes reality, GRATs will remain a go-to technique in the coming years.

Charitable Lead Annuity Trusts. Like a "zeroed-out" GRAT, a "zeroed-out" charitable lead annuity trust (CLAT) may be an attractive option for clients who are charitably inclined. Although the annuity payments to charity required to "zero-out" a CLAT may be larger than what a client may typically prefer when the client has some remaining exemption, the ability to pass the remainder free of gift tax can still produce positive results.

Qualified Personal Residence Trusts. A qualified personal residence trust (QPRT) also can be structured in a manner that results in a minimal taxable gift under the right set of circumstances. The taxable gift resulting from a QPRT is a function of the length of the QPRT term. By lengthening the QPRT term, the value of the remainder deceases, and, accordingly, so does the taxable gift.

Conclusion

The whirlwind that was 2012 is now in the history books, but the planning is far from over. We must continue to work to ensure that the plans that were so diligently implemented before the clock struck midnight on December 31, 2012 are properly administered and continue to reflect the client's estate planning objectives. And even for clients who have made gifts equal to or exceeding their exemptions, there are still plenty of highly effective techniques to reduce their transfer tax exposure in the years to come.

Reading the IRS Q&A on Net Investment Income Tax with a Focus on Estates and Trusts

On November 27, 2013, the Internal Revenue Service updated the series of Questions and Answers (the Q&A) explaining the basics of the new 3.8 percent net investment income tax (the NII tax) that it previously released on August 8, 2013. The NII tax, which came into effect on January 1, 2013, is imposed under Section 1411 of the Internal Revenue Code, a new provision added to the Code by Section 1402 of Title X of the Patient Protection and Affordable Care Act. Although the IRS published proposed regulations in December 2012 and final regulations on November 26,2013, the Q&A provides a more concise description of: (1) who must pay NII tax, (2) what's included in NII, and (3) how the tax is reported and paid.

Who Must Pay?

Questions 3-7 of the Q&A explain who's required to pay NII tax. The NII tax is applicable to individual taxpayers with modified adjusted gross income over the following amounts: $250,000 for married taxpayers filing jointly (or a qualifying surviving spouse with one or more dependent children); $125,000 for married taxpayers filing separately; and $200,000 for all other individual taxpayers, including single taxpayers or taxpayers filing as head of household. As noted in Question 3, the threshold amounts aren't indexed for inflation.

Estates and ordinary trusts are subject to the NII tax: if (1) they have undistributed NII, and (2) their adjusted gross income is greater than the dollar amount at which the highest income tax bracket for trusts and estates begins ($11,950 in 2013 and $12,150 in 2014). The NII tax will be equal to 3.8 percent of the *lesser of:* (1) the undistributed NII for the tax year, or (2) the excess of the gross income over $11,950 (or, in 2014, $12,150). Because most income generated by estates and trusts will count towards NII, affected estates and trusts are likely to experience a 3.8 percent increase in their marginal income tax rates.

In general, the NII tax is applicable only to trusts that are subject to fiduciary income tax under Part I of Subchapter J of Chapter 1 of Subtitle A of the Code. This excludes trusts that aren't classified as "trusts" for income tax purposes, such as business trusts (which are generally taxed as entities), common trust funds, designated settlement funds and other trusts subject to specific taxation regimes. In addition, trusts that are generally exempt from income tax, such as charitable trusts and qualified retirement plan trusts, are exempt from the NII tax. There are special rules for the calculation of NII with respect to charitable remainder trusts and electing small business trusts that own interests in S corporations.

As noted in Question 6 of the Q&A, trusts that are treated as "grantor trusts" for income tax purposes aren't directly subject to the NII tax. Rather, a grantor trust's NII, like all of the trust's income, deductions and credits, will be includible in the computation of the grantor's income tax.

Additionally, Question 6 notes that estates and trusts must only pay NII tax on undistributed net investment income. This is consistent with the fiduciary income tax rules, which allow for deductions of distributable net income that is required to be distributed or otherwise properly paid to beneficiaries. Instead, such income (including any items that may be considered NII) is included in the gross income of the beneficiaries who received distributions.

What's Included in NII?

Questions 8-14 discuss which items are included in NII. As a general rule, NII includes various types of income and gain that are generated by investment activities such as interest, dividends, capital gains, rental and royalty income and non-qualified annuities. In addition, income from businesses involved in trading financial instruments and commodities, as well as income from businesses that are considered "passive activities" with respect to the taxpayer, constitutes NII. As noted in Question 10, capital gains includes gains from the sale of stocks, bonds, mutual funds, investment real estate and interests in partnerships and S corporations.

When considering potential NII tax liability, fiduciaries should keep in mind that the tax is imposed on *net* investment income. As noted in Question 13, deductions that are properly allocable to investment income are allowable as deductions for computing NII tax liability as well. This may include state and local income taxes properly allocable to items included in NII.

How is NII Tax Reported and Paid?

Questions 15-18 discuss the manner in which NII is reported and NII tax is paid. Individuals, estates, and trusts will use Form 8960 to compute their Net Investment

Income Tax. The IRS website contains a link to a draft Form 8960, but the final form has not yet been released.

Individual must attach Form 8960 to, and submit payment of NII tax with, Form 1040. Trusts and estates must do the same on Form 1041. In addition, as noted in Question 16, NII tax is subject to estimated tax provisions. Fiduciaries should adjust their withholdings and estimated tax payments accordingly.

Income Tax Planning Opportunities

Both the nature of the NII tax and the differences between its application to estates, trusts and to individuals provide opportunities for income tax planning. In deciding whether a trust should be created as a grantor trust for income tax purposes, one needs to consider the potential income tax benefits of having certain items of income attributed to the grantor. In some cases, items that would otherwise be considered NII with respect to a trust might be exempt from NII tax with respect to the grantor. For example, income generated in the due course of operating a business in which the grantor is actively engaged may not be subject to NII tax in the hands of the grantor.

Considerations related to the NII tax might also influence the nature and timing of distributions to beneficiaries. Trustees may make distributions to shift income to beneficiaries whose modified adjusted gross income is less than the threshold amount. In addition, there may be advantages to distributing certain types of income producing assets (such as interests in active businesses) to beneficiaries with respect to whom the income generated wouldn't be considered NII.

The NII tax adds another layer to an already complex body of tax provisions that are applicable to estates and trusts. Please contact us if we can be of assistance with these new rules.

The Personal Planning Department at Proskauer is one of the largest private wealth management teams in the country and works with high net-worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

If you have any questions regarding the matters discussed in this newsletter, please contact any of the lawyers listed below:

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