Proskauer

Personal Planning Strategies

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Income Tax Considerations of Estate Planning Are More Important Than Ever

Gifting assets during life will reduce the size of your taxable estate at death and, correspondingly, reduce your estate tax liability. But with each lifetime transfer, now more than ever before, the income tax consequences should be weighed against estate tax savings. Because of the narrowed gap between income and estate tax rates, in some situations the income tax costs can reduce the overall tax savings significantly. However, there are certain techniques that maximize the tax savings from both a transfer tax and income tax perspective.

Gift, Estate and Income Tax Basics

In 2015, each individual can transfer up to $5,430,000 during life without incurring a gift tax. This is referred to as the “gift tax exemption,” and it increases each year as it is indexed for inflation. Upon death, each individual has an “estate tax exemption” of $5,430,000 (also indexed for inflation), less what he or she used of his or her gift tax exemption during his or her life.

For example, assume Mom has shares of stock valued at $5,430,000 that she would like to gift. If Mom gifts these shares today, she will owe $0 in gift tax and will have used up her gift tax exemption. Assuming a federal estate and gift tax rate of 40%,[1] if the shares appreciate to $10,430,000 at Mom’s death, then her gift saved $2,000,000 in federal estate tax (40% x $5,000,000, which is the amount of appreciation removed from Mom’s estate).

Now, let’s consider the income tax consequences of the above transfer. Each individual has a “basis” in each of his or her assets. One’s basis is usually the amount paid to acquire the asset. When an asset is sold, the seller must pay an income tax on the difference between the asset’s sale price and the seller’s basis in the asset. In the above example, Mom acquired the shares ten years ago for $3,430,000, making her basis $3,430,000. When Mom gifts the shares to her Son, Son takes Mom’s basis. Therefore, at Mom’s death, Son holds an asset with a fair market value of $10,430,000 and a basis of $3,430,000. If Son sells the shares, an income tax on $7,000,000 will be due. At an assumed long-term capital gains rate of 20%,[2] this would result in a $1,400,000 income tax liability for Son. Therefore, while Mom saved $2,000,000 in estate tax, the transaction cost Son $1,400,000 in income tax. The net savings is $600,000, which means the transaction is still tax-efficient, but less so than when only estate and gift tax consequences were considered.

When an individual dies, each asset included in his or her estate gets a “step-up” in basis. This means the basis of an asset becomes its fair market value as of the individual’s date of death. Therefore, had Mom bequeathed the shares to Son rather than gifted them during her life, Son would have inherited the shares with a fair market value of $10,430,000 and a basis of $10,430,000. If Son sells the shares, no capital gains tax would be due because the basis is equal to the shares’ sale price/fair market value. Mom, however, would owe an estate tax of $2,000,000 on the shares since they would be included in her estate. In this situation, there would be a net cost of $600,000, which makes retaining the asset until death an inefficient tax choice, despite the income tax savings.

As estate planners, focusing primarily on estate and gift tax savings and only tangentially on the income tax effects of transfers made sense when estate tax rates were significantly higher than capital gains rates. For example, in 2000, the top federal estate and gift tax rate was 55% and the capital gains rate was 20%. With these rates, a lifetime transfer as contemplated above would result in a net savings of $1,350,000 because Mom's estate tax savings would rise to $2,750,000. Now that the estate and gift tax rates have moved closer to the capital gains rate, the capital gains tax is extremely relevant. As shown in the paragraph above, it is still overwhelmingly beneficial to utilize one's gift tax exemption and make lifetime transfers. However, there are transactions that take advantage of lifetime gifting while simultaneously reducing future income tax liability. These transactions are discussed below.

Swapping Assets

Many trusts include a swapping power permitting the creator of the trust (also known as the "settlor" or the "grantor") to reacquire trust property by substituting other property of equal value. The trustees of the trust are obligated to ensure the incoming property is equal in value to the outgoing property.

Trusts where the settlor has this power are referred to as "grantor trusts." For estate tax purposes, a grantor trust is considered an entity separate from the settlor, and the assets held therein are excluded from the settlor's taxable estate at death. For income tax purposes, however, a grantor trust is a disregarded entity. This means any income (or loss) generated by the trust assets is attributable to the settlor, and no gain will be recognized on transactions between the settlor and the trust.

To see how the swapping power works, let’s continue with the above example and assume that the donee is a grantor trust for the benefit of Son, rather than Son individually. Mom transfers shares valued at $5,430,000, and with a basis of $3,430,000, to a trust she created. Mom owes $0 in gift tax because she used her gift tax exemption. Fast-forward 20 years to when the shares are worth $10,430,000 (and continue to have a basis of $3,430,000). Assuming Mom has wealth outside the trust, Mom can take an asset with a basis equal to or near $10,430,000, and add it to the trust. Mom would take back the shares from the trust in return. As a result, the trust holds a high basis asset, and little or no income tax would be due upon its sale to a third party by the trust. If Mom dies the following day, her estate will include the $10,430,000 shares she now holds. Mom is in the same position as if she did not do the transaction because she otherwise would have an asset valued at $10,430,000 in her estate. The benefit is that the shares’ basis would get stepped-up from $3,430,000 to $10,430,000 because they are now included in her estate. The recipient of the shares at Mom’s death now inherits an asset with a stepped-up basis equal to its fair market value. When the recipient sells the shares, he will owe capital gains tax only on the increase in the asset’s fair market value (if any) from the date of Mom’s death until the date of sale. In this situation, Mom saved $2,000,000 in estate tax, the trust owes little to no income tax when it disposes of its asset (due to the asset’s high basis) and the recipient owes little to no income tax when he disposes of the shares. The tax savings is $2,000,000 with no offsetting income tax cost.

A swap would not give rise to gift tax liability if the two swapped assets are equal in value. For this reason, it is imperative that the trustees confirm the fair market value of incoming and outgoing assets. If an asset is not readily sold on an open market, it is necessary to employ an appraiser to determine its fair market value.

Purchasing Assets

An even simpler technique is for Mom to purchase the shares from the trust. Similar to swapping assets, Mom would reacquire the shares and contribute to the trust cash and/or appreciated assets equal to the shares’ fair market value. Again, Mom would save $2,000,000 in estate tax, and the trust would have no income tax due when it disposes of $10,430,000 of cash or appreciated assets. And, because the trust is a grantor trust, the trust will not recognize any gain on the sale to Mom, because it is as if Mom sold herself the shares.

If Mom does not have enough cash to purchase the shares, she can use a promissory note to make up the difference. However, if the note is outstanding when the trust ceases to be a grantor trust, which will happen at Mom's death, there are income tax risks that could result in very unfavorable tax consequences. The specific risks are beyond the scope of this newsletter but arise due to the uncertainty of the Internal Revenue Service's treatment of a grantor trust at a grantor's death. For this reason, we only suggest using a promissory note as a last resort.

Client Considerations

If you have the luxury of picking among several assets to gift, the gifted asset should be a high basis asset. That said, with the passage of time, high basis assets can become low basis assets. Thus, the above techniques should be considered by all clients, even those gifting high basis assets today.

Additionally, you should give thought to the gift recipient's income tax situation. For example, if the donee has net-operating losses to use, the donee may prefer the low basis asset that will give rise to capital gains on sale to offset losses.

Regardless of your situation, we encourage you to speak with us to weigh the estate, gift and income tax costs and benefits of transferring assets during your life. It is especially important now to consider the income tax consequences of your estate plan and whether any technique can be employed to ameliorate future income tax liability.

New York Raises Basic Exclusion Amount to $3,125,000

On April 1, 2015, the amount of property that can pass free of New York State estate tax was increased to $3.125 million. Approximately a year ago, New York passed into a law a new and significantly overhauled estate tax regime. Although the new law will prevent the application of the New York estate tax with respect to a large number of New Yorkers, many high-net-worth individuals will continue to be liable to pay heavy New York estate taxes. In 2019, when the law is completely phased in, estates valued at less than the federal estate tax exemption amount (i.e., the amount that may pass free of federal estate tax (which is currently $5.43 million per person, as indexed for inflation)) will be exempt from New York estate tax as well. However, estates valued in excess of the federal exemption amount will continue to pay New York State estate taxes.

As set forth below, the basic exclusion amount (which was $1 million per person prior to the passage of the 2014 Executive Budget) will be increased incrementally through January 1, 2019, after which the basic exclusion amount will be tied to the federal exemption amount.

Time Period	New York Basic Exclusion Amount From
April 1, 2015 to April 1, 2016	$3,125,000
April 1, 2016 to April 1, 2017	$4,187,500
April 1, 2017 to January 1, 2019	$5,250,000
After January 1, 2019	Same as federal exemption amount (currentl $5,430,000, but increases each year for inflat

The top estate tax rate in New York in 16%. The incremental rise in the basic exclusion presents a unique opportunity to leverage the tax savings associated with the exclusion amount. Significant tax savings can be achieved if the basic exclusion amount is set aside at the death of the first spouse in trust for the surviving spouse, thereby "bypassing" federal and state estate taxation at the death of the surviving spouse (known as a "bypass" trust). Bypass trusts will continue to play a prominent role in New York estate plans because, unlike in the federal estate tax system, New York does not provide for portability of a spouse's exclusion amount. New York has a use-it-or-lose-it regime when it comes to the exclusion amount. As a result, failure to take advantage of the basic exclusion amount at the death of the first spouse by creating a bypass trust will result in a forfeiture of a crucial tax benefit. Additionally, creating a bypass trust at the death of the first spouse to die also will allow any growth that occurs in the trust to escape federal and state estate taxation at the death of the surviving spouse. As New York's basic exclusion amount rises, the potential tax benefits achieved by employing bypass trusts will increase concomitantly as well.

For taxable estates where there is no surviving spouse to inherit the assets, the new law provides that no basic exclusion amount will be available for estates valued at more than 105% of the basic exclusion amount. As a result, if an estate of a decedent dying before April 1, 2016 exceeds $3,281,250, New York estate tax will be imposed on the entire estate. For example, assume a person dies on May 1, 2015 with an estate valued at $3.3 million. Because the value of the estate exceeds 105% of the basic exclusion amount ($3.125 million x 105% = $3,281,250), the estate will be subject to New York estate tax on the entire $3.3 million. The New York estate tax bill will be $210,000. In contrast, if the same individual had died with an estate valued at $3.125 million, his or her estate would have owed no New York estate tax because it would have been entirely sheltered by the basic exclusion amount.

The paradoxical result of these rules is that an individual whose estate is valued slightly higher than the basic exclusion amount can actually save money by including charitable gifts in his estate plan to reduce the size of his or her estate. For example, had the decedent in the example above made a gift to charity of $175,000, he or she would have avoided the entire $210,000 New York estate tax, resulting in a net savings of $35,000. This tactic would only be effective in certain cases, however, because once the value of the estate reaches a particular level, taxes are imposed at a lower marginal rate.

Lifetime Gifts

Another significant change in the law involves certain gifts made during a decedent's lifetime. New York has no gift tax. However, under the new law, gifts made within three years of a decedent's death will be added back to his or her estate, and potentially can be subject to New York estate tax. However, the add-back does not include gifts made before April 1, 2014, on or after January 1, 2019, or gifts made during a time when the decedent was not a resident of New York State.

Nonresidents of New York Now Receive Full Use of the New York Exclusion Amount

Another pivotal change in the law will allow many out-of-state residents to retain property interests in New York while avoiding New York State estate tax entirely. Under the prior law, a tax would have been imposed on New York property if the gross estate was valued at more than $1 million. Pursuant to the new law, it appears that estate tax will only be imposed on New York property if the New York property itself exceeds the basic exclusion amount. For example, if a Florida resident dies on May 1, 2015 with an estate valued at $20 million, and the only New York property he owns is a pied-à-terre valued at $3 million, he would not be subjected to an estate tax in New York.

If you wish to discuss any aspect of the new law as it relates to your estate planning, please contact one of the lawyers in the Personal Planning Department at Proskauer.

Last Call for Utilizing Valuation Discounts?

Section 2704 of the Internal Revenue Code (the “Code”) is used by individuals to receive valuation discounts for gift and estate tax purposes for partial transfers of interests in controlled entities (like limited liability companies or family limited partnerships) to family members. By using this provision of the Code, many individuals have transferred minority interests in their family-controlled entities to their family members at a significantly lower transfer tax cost.

Since the Section’s enactment, the Internal Revenue Service (“IRS”) has been wary of valuation discount abuse under Section 2704. The Obama administration in particular has sought legislative change to limit valuation discounts when interests in family- controlled entities are transferred. At the recent American Bar Association’s Tax Section meeting, Cathy Hughes, from the Department of the Treasury’s Office of Tax Policy, hinted that proposed regulations could be issued which would limit the availability of valuation discounts. The scope of the potential regulations is unclear, but it is possible that the availability of valuation discounts would be severely limited as the IRS seeks to curb perceived abuses of Section 2704.

Given the increasing likelihood that regulations will be issued that will curtail the use of valuation discounts, individuals considering transferring interests in controlled entities to family members should contact us soon in order to use the favorable provisions available under current law.

[1] The top federal estate and gift tax rate is currently 40%. However, some states impose their own estate or gift tax rates, which would increase the amount of tax due.

[2] For simplicity purposes, we are ignoring the net investment income tax, which generally applies to passive income at a 3.8% tax rate.

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