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Does the Increased Estate Tax Exemption and Portability Mean the Death of Estate Planning?

Now that the federal estate tax exemption equivalent is $5,340,000 ($10,680,000 for married taxpayers) and portability has been made a permanent part of the Internal Revenue Code, many commentators have declared the death of estate planning. As Mark Twain once stated, "The report of my death has been greatly exaggerated!" That statement also applies to estate planning.

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There are tax and non-tax elements to estate planning. With the increased exemption amount and portability there are still tax considerations that come into play, even in estates that are below the federal exemption amount. Obviously, the non-tax issues are still relevant regardless of the exemptions that apply.

Tax Considerations

The American Taxpayer Relief Act of 2012 (ATRA) made portability permanent and increased the estate and gift tax exemption amount. For gifts made and decedents dying in 2014 the exemption amount is $5,340,000. It will be inflation adjusted annually. This means that a married couple can avoid the federal gift and estate tax if their combined wealth does not exceed $10,680,000.

Traditionally, wills have provided a credit shelter trust that was funded with the maximum estate tax exemption amount available on the date of death of the first spouse, to protect against the loss of that exemption. Today, many planners have changed their wills to take advantage of portability and avoid the use of the credit shelter trust. While portability provides simplicity (something that is desirable to many clients) it is not a panacea.

While our father's estate planning may not be what is necessary today, there are a number of factors that must be considered in making the credit shelter trust/portability decision. Today the value of a married couple's estate, their respective ages, their respective health and the New York State estate tax must be factored in to the decision.

Estates under $5,340,000: These are the estates for which portability was designed. However, if the clients are young and in good health, the planner must give consideration to their potential asset accumulation. Portability is still the appropriate approach as long as the clients are closely monitored as they accumulate their assets.

One problem that these estates may face relates to the New York State Estate Tax. The New York State exemption is lower than the Federal exemption. Therefore, as long as the clients have assets in excess of the New York State exemption amount a New York State credit shelter trust should be established. New York State does not recognize portability and the failure to create a credit shelter trust for the New York State exemption will create a larger estate tax on the death of the second spouse. (See the discussion, below, for a summary of the changes made to the New York State Estate and Gift tax made by the 2014-2015 Budget Bill)

Estates between $5,340,000 and $10,680,000: For these estates portability remains a viable option. That being stated, the planner should place more focus on the age of the clients and the potential asset growth. For clients whose wealth is closer to the $10,000,000 threshold, the utilization of a credit shelter trust will remove all of the growth in the value of the assets placed in that trust, from the estate of the second spouse to die. However, with capital gains rates increasing and the potential of no federal estate tax for couples in this bracket, an important factor to be considered is "step-up" in tax basis for income tax purposes.

Example: Husband and wife have an estate of $8,000,000 (Cost basis $3,000,000) consisting of real estate owned as tenants in common. On the husband's death the credit shelter trust will be funded with his half of the real estate value at $4,000,000. The credit shelter trust will get a step up in basis from $1,500,000 (one-half of the cost basis) to the $4,000,000 fair market value of the property on the date of his death. Assume that when the wife dies the value of the property in the credit shelter trust is $5,200,000. The children will inherit that property with a built-in income tax gain of $1,200,000.

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If portability was used, instead of the credit shelter trust, on the husband's death the wife will receive his property with an income tax stepped-up basis of $4,000,000. Upon her death, if she still owns that property, there will be a second step-up in basis to the value on her date of death ($5,200,000). Therefore, the children will inherit this property with no built-in income tax gain. In addition, as a result of portability she will have a federal exemption amount of $10,680,000 (without taking into account inflationary adjustments).

The decision as to whether credit shelter planning or portability is preferable can be made on the death of the first spouse to die with creative drafting. If the will creates a trust for the benefit of the spouse that qualifies for QTIP treatment (the income must be distributed to the spouse annually and during the spouse's lifetime only the spouse can receive principal distributions), this can be accomplished.

When the first spouse dies, if credit shelter planning is determined to be preferable the executor will not elect QTIP status for the trust. The trust will then effectively become a credit shelter trust. On the other hand, if it is determined that portability is preferred the executor will elect QTIP status. This will cause the trust to be included in the wife's estate allowing for the husband's exemption to port over to the wife. It should be noted that the executor could make a partial QTIP election if appropriate under the facts and circumstances.

Estates over $10,680,000: Portability may not have been designed for the wealthy, but its use should certainly be considered. Unless these couples are high spenders or poor investors, there will be some federal estate tax to pay on the death of the survivor. The planner must weigh the estate tax saving (40% federal tax rate) over a second step-up in basis (23.8% federal capital gains rate). Lifetime gifting of highly appreciating assets is still a viable estate planning technique for taxpayers in this category.

One of the interesting features of portability is the use of the deceased spouse's unused exclusion amount (DSUE) first against gifts made by the survivor. In estates of this size thought should be given to using the DSUE as soon as possible to protect against the government's potential change in the law and/or the spouse's remarriage that could result in the loss of the DSUE from the first spouse.

Finally, from a federal estate and gift tax perspective, portability does not apply to the Generation Skipping Transfer Tax. For many clients generational planning is a major factor. For these clients planning for the maximum use of the GST is still applicable.

New York State 2014-15 Budget Bill Changes

On April 1, 2014 Governor Cuomo signed the 2014-2015 New York State Budget Bill. The Bill makes major changes to the New York estate and gift tax rules. Prior to the enactment, the New York State estate tax exemption was $1,000,000 and there was no gift tax. The new law provides an increase in the estate tax exemption and an inclusion in the decedent's gross estate of gifts made within three years of death.

The Budget Bill increases the New York State estate tax exemption as follows:

- For deaths on or after April 1, 2014 and before April 1, 2015 – $2,062,500
- For deaths on or after April 1, 2015 and before April 1, 2016 – $3,125,000
- For deaths on or after April 1, 2016 and before April 1, 2017 – $4,187,500
- For deaths on or after April 1, 2017 and before Jan. 1, 2019 – $5,250,000
- For deaths after December 31, 2018, the exemption amount will be indexed for inflation consistent with the federal estate tax exemption.

However, the new law contains a special provision; referred to as a "cliff." If the decedent's taxable estate exceeds 105% of the estate tax exemption the estate will "fall off the cliff" and the increased New York State exemption will be lost. Therefore, the estate will be subject to the $1,000,000 exemption in lieu of the new increased exemption amount. If a decedent died on or after April 1, 2014 and before April 1, 2015 with a taxable estate of more than $2,165,625 the increased estate tax exemption is lost.

Governor Cuomo's original proposal to increase the New York State exemption amount also included a provision to reduce the top tax rate from 16% to 10% over a period of years. The new law retains the 16% top tax rate, for estates of individuals dying before April 1, 2015. This rate applies to taxable estates in excess of $10,100,000. The New York State legislature may revisit the reduced rate in future Budget Bill discussions.

For gifts made by a resident of New York State on or after April 1, 2014 and before January 1, 2019, the law provides an add-back to the estate on death of all taxable gifts made within three years of the decedent's death. It should be noted that this is not a reinstatement of a New York State gift tax but an addition to the gross estate of a New York State decedent.

As the New York State Exemption approaches the Federal Exemption the use of a New York State credit shelter trust will limit or eliminate the ability to use portability for federal purposes and the use of the technique, set forth above, to obtain the double step-up in basis. In addition, the New York State exemption "cliff" creates planning and will drafting problems for clients and their estate planners.

Non-Tax Considerations

Even where tax planning may not be necessary, estate planning is still an important step for clients. The traditional considerations of asset distribution among beneficiaries and the naming of fiduciaries and guardians remain as an essential aspect of planning. In addition to these general issues, inherent in every plan, a well-constructed design for an estate should consider:

1. The establishment of trust for the surviving spouse to protect the assets from a second spouse or family, to provide financial assistance in investing the assets of the trust, or to create creditor protection.
2. The establishment of trusts for minor or adult children to, again, provide creditor protection, investment assistance or to ensure the proper ultimate distribution of the assets.
3. The establishment of special needs trusts for beneficiaries who are collecting federal or state benefits.
4. The use of charitable giving, and the creation of a charitable legacy, either outright or in trust.
5. The potential for the need to plan for second marriages.
6. The desire of the client to provide for pets.
7. The necessity to create a special distribution pattern relative to the ownership of business assets, especially in a circumstance where one or more children are active in the business and other children are not.

Conclusion

It is clear that while estate planning has changed, it has not died. In fact, any client that has a will drafted before 2010 (when portability was first enacted and before the enactment of the 2014-2015 New York State Budget Bill) should be notified that their will needs review.

With the dramatic changes to the rules governing estate and gift taxes over the past few years, many wills contain provisions that are no longer required. Many plans that were previously based solely on the impact of the transfer taxes must be reviewed relative to income tax consequences that may now have a greater impact. For those without significant tax concerns, the issues related to beneficiaries, fiduciaries and distribution patterns move to the forefront of the decision making process.

Those whose practices focus on estate planning need not fear. We are all still very much needed. Just, perhaps … for a slightly different purpose.

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