The Evolution of Estate Planning

by James S. Judd

Overview

The American Taxpayer Relief Act of 2012 (ATRA), enacted January 2, 2013, drastically changed the landscape of estate planning. Under the federal estate and gift tax provisions of ATRA, the federal estate tax exemption of $5 million was made permanent and indexed for inflation ($5.43 million for 2015). ATRA also solidified the "portability" of a deceased spouse's unused federal estate tax exemption. These changes now allow married couples to shelter $10.86 million from federal estate tax in 2015 by merely leaving everything to a surviving spouse with a simple will. As a result, according to the Center for Tax Policy, approximately 99.8% of Americans will not be subject to any federal estate tax.

Although ATRA lessened the impact of the federal estate tax, it significantly increased the impact of the federal income tax on individuals, estates, and trusts by raising the maximum tax bracket from 35% to 39.6% and raising the capital gains tax on the highest income tax bracket from 15% to 20%. Although not a part of ATRA, the new Medicare tax of 3.8% on "net investment income" also increases the sting of federal income tax.

Income Tax Planning for Estates

Prior to ATRA, estate planning focused primarily on avoiding federal estate tax by using the federal estate tax exemption as early as possible during a taxpayer's life and avoiding the inclusion of assets in a taxpayer's estate. Federal income tax considerations were less important because of lower federal income tax rates and broader federal estate tax application. ATRA has changed the focus for a majority of taxpayers, from federal estate tax avoidance to federal income tax avoidance. Consequently, estate planners now have an increased motivation to structure estate plans that maximize the inclusion of assets in a taxpayer's estate because assets included in a taxpayer's estate will receive a basis step-up and eliminate or substantially reduce federal income tax on a subsequent sale of the assets. This type of tax basis management, now more than ever, will become a critical part of estate planning.

As estate planning evolves from federal estate tax avoidance to federal income tax avoidance, estate planners will implement more creative and aggressive strategies to avoid the increased sting of the federal income tax. "Reverse estate planning" is a strategy that may become progressively more popular due to the effects of ATRA. Using reverse estate planning, an estate planner may seek to use the federal estate tax exemption that is available to a client's modest-income parent in order to obtain a basis step-up in the client's property. For example, a reverse estate planning strategy may consist of having a client transfer low-basis stock to an elderly parent and when the elderly parent dies, having the stock transferred back to the client. When the stock is transferred back to the client at the parent's death, the client will obtain a full basis step-up in the stock and can immediately sell the stock without any federal income tax implications.

Section 1014(e) of the Internal Revenue Code

When an estate planner engages in reverse estate planning, caution must be taken to avoid the pitfalls of 26 U.S.C. § 1014(e) of the Internal Revenue Code. If § 1014(e) applies, the taxpayer will not receive a basis step-up at the death of the parent but will

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receive a basis equal to the parent's basis in the property immediately prior to the parent's death.

Although § 1014(e) was enacted in 1981, there is a lack of authority providing interpretation and application of the section. The IRS has not issued any Treasury Regulations providing guidance on § 1014(e) and announced in 1986 that it closed its project to construct interpretive regulations. For a more complete explanation and understanding of § 1014(e), see Jeff Scroggin, *Understanding Section 1014(e) and Tax Basis Planning*, Leimberg Est. Pl. Email Newsletter #2192 (Feb. 6, 2014). The lack of interpretation of § 1014(e) makes it difficult to understand how the IRS will enforce it as estate planners increasingly seek to assist clients in avoiding the sting of the federal income tax. According to the provisions of § 1014(e), it will apply if the three following circumstances are present: (1) there is a gift of an appreciated asset; (2) the gift occurred within one year of the donee's death; and (3) the gifted asset is reacquired by the donor.

26 U.S.C. § 1014(e).

With federal income tax avoidance becoming paramount to estate planning, an estate planner's client may insist on implementing an estate plan that uses the imminent death of a terminally ill parent in order to get a basis step-up in the client's assets. Since the terminally ill parent is likely to die within one year of the transaction, § 1014(e) would apply and disallow a basis step-up. However, an estate planner may possibly avoid the application of § 1014(e) by structuring a transaction with the following four steps:

(1) the client makes a gift of cash to the client's grantor trust;

(2) the client gives a testamentary power of appointment over the trust to the client's parent;

(3) appreciated assets are sold to the trust in

exchange for the previously gifted cash; and

(4) the parent exercises the power of appointment in favor of the client.

This transaction should escape the reach of § 1014(e) if the terminally ill parent dies within one year of the gift because the initial gift of cash was not a gift of appreciated assets. The appreciated assets were purchased by the trust and not gifted by the client. Moreover, the purchase of the appreciated assets by the grantor trust will not trigger a taxable gain since grantor trusts are disregarded for federal income tax purposes. This strategy has been attributed to prominent trust and estates lawyer Jonathan Blattmachr.

It is possible that the IRS will challenge such transactions under the "step transaction doctrine" or "substance over form doctrine." Using these two doctrines, the IRS may assert that the initial gift of cash and subsequent purchase of appreciated assets with the gifted cash was a "constructive gift" of appreciated assets. It is also possible that the IRS will try to expand the reach of § 1014(e) to disallow a basis step-up in these types of transactions.

As a result of ATRA, there will be a substantially higher number of estate plans that focus on federal income tax avoidance instead of federal estate tax avoidance. As estate planners use aggressive strategies to avoid the increased sting of the federal income tax, the IRS will likely seek to broaden the reach of § 1014(e), and likely other sections, in order to limit the ability to avoid federal income tax.

Relevance of AB Trusts

Prior to ATRA, couples could pass two times the federal estate tax exemption only by implementing "AB Trusts." AB Trusts were commonplace and used in virtually all estate plans. The B Trust, i.e., the credit shelter trust, was funded with the first deceased spouse's assets up to the amount of the deceased's spouse's federal estate tax exemption, while the A Trust, i.e., the marital trust, was funded with any amount exceeding the deceased spouse's federal estate tax exemption. With ATRA making portability permanent, it is no longer necessary to use AB Trusts to allow a married couple to use a deceased spouse's federal estate tax exemption. Does this render AB Trusts irrelevant?

Now that portability allows a couple to pass twice the federal estate tax exemption without the use of AB Trusts, the disadvantages of using AB Trusts may outweigh any remaining benefits. Three major issues must be considered when using AB Trusts in the wake of portability. First, at the death of the surviving spouse, the B Trust becomes irrevocable. Thus, the surviving spouse is required to strictly adhere to the exact terms of the B Trust. This significantly limits estate plan modifications after the death of a spouse since a significant part of the estate assets may be subject to the irrevocable terms of the B Trust.

> *"With ATRA making portability permanent, it is no longer necessary to use AB Trusts to allow a married couple to use a deceased spouse's federal estate tax exemption."*

The second issue with AB Trusts is that B Trust assets do not receive a basis step-up at the death of the surviving spouse. Although the assets funded in the B Trust receive a basis step-up at the death of the first deceased spouse, the basis of the B Trust assets remains unchanged at the death of the surviving spouse. Thus, if the surviving spouse outlives the deceased spouse by ten years, there will be ten years of appreciation subject to federal income tax. The federal income tax on such appreciation could have been avoided with an estate plan that "bypassed" the use of AB Trusts.

The third issue with AB Trusts is that the B Trust results in high administrative costs. At the death of the first deceased spouse, there will be administrative costs associated with the division of assets and additional costs for administering the separate trusts over the surviving spouse's lifetime. Furthermore, there must be separate income tax returns/K-1s prepared for the beneficiaries of the B Trust. Thus, the AB Trust structure results in significantly higher administration expenses than if a couple merely relied on the portability of a deceased spouse's federal estate tax exemption.

With the passage of ATRA, the disadvantages of AB Trusts likely outweigh any advantages. However, since federal tax law is constantly changing, a taxpayer may insist on the existence of an AB Trust structure to act as a safety precaution in the event that portability is later revoked by Congress. An effective solution to avoid the potential pitfalls of the AB Trust structure is a disclaimer provision. A properly drafted disclaimer provision will direct that the B Trust will only be funded with the assets that are "disclaimed," i.e., rejected, by the surviving spouse. This allows the surviving spouse to determine whether it makes sense to fund the B Trust at a spouse's death. The surviving spouse does not have to make the decision to disclaim immediately after a spouse's death but will have nine months after the spouse's death to determine whether to disclaim any assets. The disclaimer provision will effectively prevent a surviving spouse from being forced to adhere to the irrevocable terms of the B Trust in the event that the surviving spouse desires greater flexibility in avoiding the AB Trust structure entirely.

Conclusion

Although ATRA has lessened the impact of the federal estate tax, it has significantly increased the sting of the federal income tax. As a result, a majority of individuals will need estate plans that seek income tax avoidance through proper tax basis management. ATRA has also significantly lessened the need for AB Trusts. Thus, estate planners will want to consider revising AB Trust estate plans by implementing a disclaimer provision, which will allow a taxpayer the ability to avoid the possible disadvantages of an AB Trust structure.