The Estate Planning World Has Been Turned Upside Down By ATRA --
A View from the Audience at Heckerling (2014)
by Kevin Matz[1]

The recently concluded 48th Annual Heckerling Institute on Estate Planning posed more questions than answers and challenged estate planners to take a fresh look at the role of income tax (and income tax basis) planning in advising our clients. More than one year has now passed since the paradigm shift in the overall estate planning landscape that was ushered in by the American Taxpayer Relief Act of 2012 ("ATRA"). Although ATRA instilled some degree of stability in the estate, gift and generation-skipping transfer ("GST") tax systems through the elimination of sunset provisions to favorable exclusion amounts, tax rates and GST tax rules, the consensus at this year's Heckerling Institute was that estate planning – particularly for clients in the $ 5 million to $ 10 million range – is much more complex than ever due to the multitude of variables that will have to be considered in a well-structured plan. Indeed, given that for 2014 up to $ 5,340,000 ($ 10,680,000 for a married couple) can pass free of federal estate tax, the new paradigm requires a case-by-case analysis of the role that income tax planning (and achieving a step-up in basis upon the surviving spouse's death) now plays in light of our clients' particular circumstances. More than ever, the need for flexibility is paramount.

Accordingly, the primary message from this year's Heckerling Institute was that any lingering notion of a one-size-fits-all solution to estate planning must be immediately abandoned. Rather, every client's circumstances must be carefully evaluated in light of the

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double step-up in basis that may be achievable through portability, taking into account the implications of state estate taxes as well. Simply put, estate planners must now become income tax law specialists to the same extent that they are estate, gift and GST tax law specialists.

What this all means in a practical sense is that preserving the ability to delay decisions to the post-mortem context (such as through qualified disclaimer planning and the use of Clayton qualified terminable interest property ("Clayton QTIP") elections) is now the name of the game. In addition, opportunities must be aggressively mined to force estate tax inclusion in non-estate taxable estates (taking into account state estate taxes as well) to fully utilize the tremendous vehicle for obtaining a tax-free step-up in basis that ATRA can provide.

Income Tax Versus Estate Tax, and Proactive Tax Basis Management

The most riveting plenary presentation at this year's Heckerling Institute was delivered by Paul S. Lee, a National Managing Director at Bernstein Global Wealth Management. Mr. Lee challenged the audience to accept that the world has now been turned upside down, and that with the increase in the federal applicable exclusion amount to $ 5,340,000 in 2014 ($ 10,680,000 for a married couple) considered in tandem with the permanence of portability of the deceased spouse unused exclusion ("DSUE") amount, the best use of the applicable exclusion amount will often be *to preserve it* (as opposed to consuming it through lifetime gifts) to maximize the step-up in basis upon death (including upon the surviving spouse's death). This is nothing short of revolutionary. If the name of the game has now changed to preserve applicable exclusion amount as the primary tax-driver in estate planning, all of the techniques in an estate planner's toolkit must now be reexamined through a completely different lens that carefully scrutinizes whether a lifetime transfer constitutes a justifiable expenditure of the applicable exclusion amount, all things considered. Thus, strategies that minimize the use of the applicable exclusion amount – such as grantor retained annuity trusts ("GRATs") [2] and loans and sales to intentionally defective grantor trusts ("IDGTs") [3] – can be expected to be among the most favored techniques in this brave new world going forward.

In addition, proactive tax basis management becomes extremely critical in this new world. The old stalwart of planning with IDGTs can be extremely helpful here because the Internal Revenue Service, in Rev. Rul. 2008-22, held that the grantor's retained power under IRC § 675(4)(C)[4] to substitute assets of equivalent value in a nonfiduciary capacity will not trigger estate tax inclusion under IRC § 2036 provided that adequate fiduciary safeguards are in place to ensure that the value of the assets swapped into the trust are equivalent to the value of the assets swapped out of the trust. Thus, swapping high-basis assets (such as cash) into an IDGT in exchange for low-basis assets held by the IDGT (such as publicly traded securities with a low-cost basis) can be expected to be in vogue.

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[2] A GRAT involves a grantor's transfer of property to an irrevocable trust (the GRAT) for a specified number of years, retaining the right to receive an annuity (a fixed amount payable not less frequently than annually). Upon termination of the GRAT, the trust assets are paid to the remaindermen named by the grantor, typically his or her children, or to a trust of which the grantor's spouse and issue are beneficiaries. In essence, the grantor creates a GRAT to transfer its <u>remainder</u> at termination. This transfer is a taxable gift that is deemed to occur upon creation of the GRAT. The remainder is valued for tax purposes by subtracting the interest retained by the grantor—the annuity—from the value of the initial transfer into the GRAT. The Internal Revenue Service ("IRS") requires that the value of the retained annuity be calculated on an actuarial basis using the assumed interest rate published by the IRS under Section 7520 of the Internal Revenue Code that is in effect for the month that the GRAT is funded.

[3] An IDGT is an irrevocable trust for which one of the "grantor trust" provisions set forth in IRC §§ 671-679 is triggered. Transfers by the grantor to the IDGT will be complete for gift tax (and estate tax) purposes but incomplete for income tax purposes. Therefore, if the trust is drafted properly, the income and gains of the trust will be taxable to the grantor, but the assets transferred to the trust by the grantor will be excluded from the grantor's gross estate upon death. Further, the grantor's payment of income taxes attributable to the trust will not constitute a gift for Federal gift tax purposes because the grantor is discharging his own legal obligation. *See* Rev. Rul. 2004-64. In addition, transactions between the grantor and the grantor trust will not be taxable events. *See* Rev. Rul. 85-13. These tax benefits of IDGTs under current law are all on top of the wonderful asset protection and property management benefits that trusts can provide.

[4] All references to "IRC" are to the Internal Revenue Code of 1986, as amended.

Moreover, Mr. Lee posited that partnerships (and limited liability companies) may provide the ultimate vehicle for proactive tax basis management. For example, a partial liquidation of partnership assets in favor of a senior generation family member where a Section 754 election is made could potentially "strip basis" from the distributed assets, and cause the amount of the stripped basis to be allocated among the remaining undistributed partnership property.[5] Presumably, substantial partnership interests in such partnership may be held by younger generation family members or trusts established for their benefit. The distributed assets whose basis has been stripped (to give them a zero tax basis) would then benefit from a step-up in basis if the senior generation family member were to die holding them.[6]

In addition, this new world of proactive tax basis management recognizes that every U.S. citizen and resident possesses a valuable asset that can be put to productive use – namely, a federal applicable exclusion amount that in 2014 can shelter up to $ 5,340,000 from estate tax while facilitating a step-up in basis for assets to which it is applied. Thus, estate planners can be expected to include provisions within their wills and trust instruments that confer upon an independent trustee, or a trust protector, the ability to grant a general testamentary power of appointment to beneficiaries so that a step-up in basis of the assets that are subject to such power of appointment may be achieved upon the beneficiary's death. To the extent that existing trusts do not already contain such provisions, a trust decanting or modification may be employed to engineer this result.

Moreover, determining the appropriate course to take is highly sensitive to the particular state in which the client resides, because some states (such as California and Florida)

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5 *See* IRC § 734(b).

6 *See* IRC § 1014.

do not impose any state estate tax, or have community property law concepts (California) that will automatically facilitate a double step-up in basis upon the first spouse's death. In sharp contrast, other states (such as New York) impose substantial estate taxes (although the New York estate tax laws may now be in flux, as further described in this article). Further, we now live in a world in which, depending upon the decedent's state of residence at the time of death and where the beneficiaries reside, the spread between the aggregate estate tax rate (federal and state) and the aggregate capital gains tax rate (federal and state) for appreciated property may be relatively small, particularly when one takes into account the 3.8% additional tax on net investment income under the Patient Protection and Affordable Care Act.

Grappling with Portability More Than One Year After ATRA

Now that portability of the DSUE amount is permanent under ATRA, estate planning advice to married clients who have significant amounts of unused applicable exclusion amount should generally consider the pros and cons of relying on portability either in lieu of, or in conjunction with, establishing a traditional credit shelter trust. The consensus at Heckerling (including in the excellent presentations by the Recent Developments Panel and by Thomas W. Abendroth, a partner at Schiff Hardin LLP) was that planning for married clients in the $ 5 million to $ 10 million range is much more difficult than planning for married clients who are either well above or well below that range.

ATRA established as permanent the portability of the applicable exclusion amount between spouses where the first spouse to die is either a U.S. citizen or a U.S. resident. Portability, in a nutshell, involves the carryover of the first decedent spouse's unused applicable exclusion amount to the surviving spouse for estate and gift tax purposes (but not for GST tax purposes) and can be accomplished through the executor's election on the estate tax return of the first spouse to die.

Portability will ensure a step-up in basis of the subject assets at the surviving spouse's death and may appeal to clients as a reason to avoid having to plan their estates. The consensus at Heckerling, however, was that portability does not dispense with the need to consider using credit shelter trusts (which could include a trust of which the sole lifetime beneficiary is the surviving spouse) in estate planning in many instances. Indeed, it is incumbent upon the estate planner to "drill down" on the facts in order to advise the client how best to proceed.

The following considerations may continue to support the use of credit shelter trusts in lieu of relying exclusively on portability:

- There are substantial non-tax benefits to be derived from using trusts, including asset protection, asset management, and to restrict transfers of assets by a surviving spouse (particularly if there are children from a prior marriage, or concerns about a subsequent remarriage).
- Portability does not generally apply for *state* estate tax purposes, including in "decoupled" states such as New York. Thus, a well-drafted estate plan for a New York married couple might still involve funding a credit shelter trust with the largest amount capable of passing free of New York State estate tax (currently $1,000,000) to avoid wasting the New York State estate tax exemption of the first spouse to die.
- A step-up in basis may nevertheless be achieved over assets in a credit shelter trust by giving the surviving spouse a general power of

appointment over the property of the credit shelter trust (such as by allowing the surviving spouse to designate by her Will that some portion of the trust property shall be paid over to her estate upon her death) in a formula amount equal to the largest amount capable of passing free of federal estate tax as finally determined for federal estate tax purposes. This general power of appointment will cause estate tax inclusion over the property that is subject to it, thereby producing a step-up in basis to such extent.

- The DSUE amount is not indexed.
- Depending upon subsequent facts and circumstances, the DSUE amount may be lost if the surviving spouse remarries and survives his or her next spouse.
- With portability, growth in assets is not excluded from the gross estate of the surviving spouse. In contrast, growth in the assets of a credit shelter trust is excluded from the gross estate of the surviving spouse.
- A credit shelter trust can be used to shield hard-to-value assets from valuation disputes with the Internal Revenue Service upon the death of the surviving spouse, because such assets would not be part of the surviving spouse's gross estate.
- There is no portability of the GST tax exemption. So planning with trusts (including lifetime QTIP trusts for which a reverse QTIP election under IRC § 2652(a)(3) would be made) will still generally be warranted if GST tax planning for grandchildren and more remote descendants is desired.

- A well-conceived estate plan could involve relying upon the portability of the applicable exclusion amount and then having the surviving spouse gift the DSUE amount to an IDGT to obtain the benefits of grantor trust status that generally would not be available for a credit shelter trust, including effective income tax-free compounding of the trust principal and the ability to "swap" assets from time to time to achieve a *de facto* step-up in basis upon the second spouse's death.

In light of the Supreme Court's decision in *United States v. Windsor*,[7] which invalidated as unconstitutional Section 3 of the Defense of Marriage Act (which had defined marriage as requiring a legal union between one man and one woman), portability is also available to same-sex couples. In Rev. Rul. 2013-17,[8] the Internal Revenue Service addressed certain implications of the Supreme Court's decision in *Windsor*, ruling that a "state of celebration" test applies. Under this Revenue Ruling, same-sex couples who are legally married in states or foreign countries that recognize the validity of their marriage will be treated as married for all federal tax purposes, even if they live in a state or other jurisdiction that does not recognize same-sex marriages. So estate planning for same-sex couples must now consider the same factors concerning portability that apply to planning for opposite-sex couples.

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[7] *United States v. Windsor*, 570 U.S. ___, 133 S.Ct. 2675 (2013).

[8] Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

More Changes May Be on the Horizon, Although Probably Not This Year

The consensus at Heckerling was that because 2014 is an election year, there is unlikely to be any major tax reform this year. The year 2015, however, could potentially be a different story.

What looms on the horizon for 2015 and beyond? Although the tea leaves can be difficult to read, the Obama Administration's Fiscal Year 2014 tax ("Greenbook") proposals that pertain to estate planning, which were released in April 2013, provide a broad outline of what *could* potentially happen down the road, subject of course to the inevitable horse-trading that marks the legislative process.

A summary of several of the key provisions of the Fiscal Year 2014 Greenbook proposals is set forth below. Conspicuously absent from the 2014 Greenbook is the Obama Administration's long-time stalwart proposal to eliminate marketability discounts for interests in family-owned entities that hold passive assets, such as marketable securities.

1. The Estate, Gift and GST Tax Exclusions and Rates Would Revert Back to 2009 Rules

The Obama Administration proposes to restore the 2009 estate, gift and GST transfer tax exclusions and rates beginning in 2018. Under this proposal, the estate and GST tax exemption amounts would be reduced to $ 3,500,000, while the gift tax exemption would be reduced to $ 1,000,000. There would no longer be any indexing of these exemption amounts for inflation. The top tax rate would be increased to 45% from the current top rate of 40%. Portability would, however, continue in effect.

The Administration's proposal clarifies that there would be no "clawback" for prior transfers by reason of the reduction in the estate, gift and GST tax exemption amounts.

Accordingly, if this proposal were enacted into law, it would most likely prompt another rush of gifting for wealthy individuals in late 2017 similar to the recent gifting rush at the end of 2012.

2. Sales, Exchanges and "Comparable Transactions" with Grantor Trusts

The Obama Administration would attempt to address the "disconnect" between the income tax rules and the estate tax rules that apply to "intentionally defective grantor trusts" ("IDGTs"). However, in stark contrast to the previous year's vastly overbroad Greenbook proposal concerning grantor trusts – which would have generally sought to include most grantor trusts in the decedent's gross estate for estate tax purposes – the Fiscal Year 2014 proposal is much more narrowly drawn and would only be triggered in the case of certain *transactions with grantor trusts* that constitute a "*sale, exchange or comparable transaction* that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust." In the case of such transactions, the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments of such property), net of the amount of the consideration received by the person in that transaction, (i) would be subject to estate tax as part of the gross estate of the deemed owner, (ii) would be subject to gift tax when grantor trust status ceases as to the deemed owner during such person's lifetime, and (iii) would be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to such other person) during the life of the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

Thus, the current proposal would allow IDGTs to be created, but would not allow taxpayers to sell or exchange assets to an IDGT (or engage in a "comparable transaction") without potential adverse tax consequences. An "exchange" presumably could include a grantor's exercise of a power to substitute assets of equivalent value in a nonfiduciary capacity, which is a commonly used trigger for grantor trust status under IRC § 675(4)(C). It is unclear what this proposal means through its reference to "comparable transactions" and whether that would embrace, for example, making loans to the trust, or leasing back real property (such as a vacation home) from the trust.

Significantly, the 2014 Greenbook proposal specifically excludes from its ambit trusts that are grantor trusts solely by reason of IRC § 677(a)(3), which pertains to the application of income to pay life insurance premiums. Thus, such narrowly drawn irrevocable life insurance trusts would not be subject to estate tax inclusion merely because they are grantor trusts, perhaps even if the specified transactions described above were engaged in. In addition, the proposal would not alter the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code (such as grantor retained annuity trusts and qualified personal residence trusts).

This proposal would apply to transactions entered into on or after the date of enactment.

3. Additional Restrictions on Grantor Retained Annuity Trusts

The Obama Administration would significantly reduce the attractiveness of grantor retained annuity trusts ("GRATs") by, among other things, requiring a minimum term of ten years (thereby eliminating short-term rolling GRATs), preventing the ability to front-load the GRAT annuity, and imposing a minimum taxable gift requirement. In addition, to combat the perceived abuse of "99-year GRATs," the Obama Administration would limit the maximum term of a GRAT to the annuitant's life expectancy plus ten years.

4. Additional Greenbook Proposals That Pertain to Estate Planning

The Administration's 2014 Greenbook contains the following additional proposals that pertain to estate planning:

- A proposal that would change existing law under IRC § 101 by subjecting "buyers of policies" to the "transfer-for-value" exception to the exclusion of life insurance proceeds for income tax purposes. The phrase "buyers of policies" presumably is broad enough to encompass grantor trusts. If enacted, such "buyers of policies" would be taxed on death benefit proceeds in excess of the amount of consideration furnished.
- A proposal that would limit the scope of the current law exclusion under IRC § 2611(b)(1) for GST tax purposes for direct payments of tuition and medical care so that this exclusion would only apply to payments *made by a living donor* directly to the provider of medical care or to the school for tuition. As a result of these restrictions, trust distributions for these same purposes -- including in the case of so-called "Health and Education Exclusion Trusts" ("HEET Trusts") -- would not qualify for this exclusion.
- A proposal that would impose a consistency requirement for basis purposes between what is reported as fair market value on the decedent's Form 706 Federal Estate and Generation-Skipping Transfer Tax Return (presumably, as finally determined for Federal estate tax purposes), and what the beneficiary later reports as his or her stepped-up basis upon the decedent's death for income tax purposes.

- A proposal that would limit the availability of the GST exemption to 90 years.
- A proposal that would extend the 10 year estate tax lien under IRC § 6324(a)(1) to cover the entire 14 year and 9 month term subsequent to the decedent's death that is subject to the deferral of estate tax under IRC § 6166.
- A proposal that would restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation.

5. Related Proposals Pertaining to Qualified Plans and Individual Retirement Accounts

In addition, the Fiscal Year 2014 Greenbook includes the following proposals that pertain to qualified plans and individual retirement accounts:

- A proposal that would limit the total accrual of retirement benefits by prohibiting additional contributions or the receipt of additional accruals if the taxpayer has accumulated retirement benefits in excess of the amount necessary to provide the maximum annuity permitted under a defined benefit plan (currently $ 205,000 per year payable as a joint and 100% survivor annuity beginning at age 62). This amount is currently approximately $ 3,400,000 at age 62.
- A proposal that would generally require non-spouse beneficiaries of qualified retirement plans or IRAs to take distributions over no more than five years. Exceptions would apply for beneficiaries who are disabled, chronically ill, up to 10 years younger than the participant or IRA owner,

or a minor child (the minor child's five-year distribution period would commence upon attaining the age of majority).

- A proposal that would extend to non-spouse beneficiaries the ability to make sixty (60) day rollovers of distributions from qualified plans or IRAs to non-spousal inherited IRAs. This proposal would afford non-spouse beneficiaries the same treatment for 60-day rollover purposes that surviving spouses currently enjoy.
- A proposal that would exempt participants and IRA owners with aggregate benefits under $ 75,000 from having to take required minimum distributions.

Evolving State Tax Law Developments – A Look at New York

Finally, consistent with the theme at this year's Heckerling Institute that each state provides its own separate paradigm for estate and income tax planning, it is instructive to consider recent developments in New York that occurred during the week immediately following the 2014 Heckerling Institute.

On January 20, 2014, Governor Cuomo issued the New York State Executive Budget (the "Budget Bill"). The Budget Bill includes the following proposals that pertain to estate planning and trusts:

- A proposal to reform the New York estate tax (i) by raising the New York estate tax exemption from $ 1 million to $ 5.25 million, subject to further indexing, and (ii) by reducing the maximum New York estate tax rate from 16% to 10%. Both the increased exemption and the decreased rates would be phased in over four years with the New York estate tax exemption to be approximately equal to the Federal estate tax exemption, indexed for inflation, beginning in 2019.

- A proposal to reform the New York estate tax by permitting a separate state qualified terminable interest property ("QTIP") election to be made where no federal estate tax return is required to be filed, although a federal estate tax return may in fact have been filed.
- A proposal to eliminate the New York generation-skipping transfer ("GST") tax, which applies to taxable distributions and taxable terminations from a trust to a "skip person" for GST tax purposes.
- A proposal to provide for an "addback" of taxable gifts under IRC § 2503 that are made on or after April 1, 2014 if the decedent was a resident of New York at the time such gift was made.
- A proposal to subject "incomplete gift nongrantor trusts" ("ING Trusts") to New York income tax by treating such trusts as grantor trusts for New York income tax purposes.
- A proposal to subject to New York income tax on a "throwback tax" basis "accumulation distributions" to New York resident beneficiaries from nongrantor trusts (other than "ING Trusts") that are currently exempt from New York income tax [A] under the "New York Resident Trust Exception," or [B] as nonresident trusts that do not have any New York source income. The New York Resident Trust Exception applies to nongrantor trusts for which (1) all of the trustees are domiciled outside of New York State; (2) all

real and tangible trust property is located outside of New York State; and (3) all trust income and gains is derived from sources outside of New York State.[9]

How this all plays out will likely be addressed at next year's Heckerling Institute.

[9] *See* N.Y. Tax Law § 605(b)(3)(D).