CURING ESTATE PLANS THAT NO LONGER MAKE SENSE IN LIGHT OF ATRA

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2000 vs. 2015

- AEA increased from $675,000 to $5,430,000
- GST Exemption increased from $1,030,000 to $5,430,000
- Maximum transfer tax rate reduced from 55% to 40%
- Basic exclusion: use it or lose it – now portable

2000 vs. 2015

- CPI increased 39%
- Gift & estate tax exclusions increased 704%
- GST exemption increased 427%
- Maximum transfer tax rate decreased 27%

How many clients face transfer tax issues?

- Estate tax returns declined 87% from 73,100 in 2003 to 9,400 in 2012.
- 99.62% of 2012 decedents didn't file Form 706.
- Households in the 95% percentile had a net worth of $1,365,000.
- Federal wealth transfer tax system not applicable to most taxpayers

Heightened sensitivity to income taxes

- Maximum federal income tax rate increased from 35% to 39.6%
- Long-term capital gains and dividends increased from 15% to 20%.
- HCA added a 3.8% tax on Net Investment Income "NII."

Heightened sensitivity to income taxes

- Most affluent taxpayers face with:
  - 43.4% tax on ordinary income;
  - 23.8% tax on long-term capital gains & dividend.;
- State and local taxes can increase the tax burden:
  - Hawaii:
    - 51.23% for ordinary income & STCG
    - 35.99% for dividends & LTCG
  - New York City:
    - 52.26% for ordinary income & STCG
    - 37.69% for dividends & LTCG

ATRA & HCA create a new paradigm

- Techniques designed to reduce transfer tax can increase potential income tax.

- Bypass trust:
  - Assets: $3 million with a $1 million basis
  - Surviving spouse dies in 2015 with a $2 million estate
  - Descendants receive $5 million – but with a built-in gain of $2 million.
  - If no bypass trust, descendants would receive same assets but with a full FMV basis.

ATRA & HCA create a new paradigm

- Planning that made sense prior to ATRA now may be detrimental.

- ATRA is not guaranteed to be permanent:
  - Administration's proposed 2015 budget.
    - Reduce estate and GST exemptions to $3.5 million
    - Reduce gift tax exemption to $1 million
    - Increase the top tax rate to 45%
  - Congressional proposal to repeal transfer taxes.

Purpose of presentation

- Identify existing planning transactions that no longer make sense to taxpayers.
- Discuss how taxpayers may attempt to escape from those transactions.
- Discuss how taxpayers may more efficiently administer transactions that they cannot escape.

ATRA inspired strategies

1. Avoiding valuation discounts for taxpayer-owned assets;

2. Causing inclusion of trust assets in the settlor's estate;

3. Causing inclusion of trust assets in a beneficiary's estate;

4. Causing inclusion of trust assets in a third party's estate

5. Causing inclusion of gifted assets (not in trust) in the donor's estate;

ATRA inspired strategies

6. Changing ownership of spousal assets to achieve a new income tax basis for appreciated assets and to preserve the income tax basis of "loss assets";

7. Avoiding imposition of the 3.8% net investment income tax ("NIIT");

8. Addressing life insurance policies and life insurance trusts that are no longer needed; and

9. Turning off grantor trust status to avoid unnecessary wealth shifts and to facilitate income tax planning.

ATRA inspired strategies

- For each strategy:
  - Identify existing techniques that invite its use.
  - Suggest specific actions to implement the strategy.
  - Discuss the following issues:
    - Income taxes;
    - Transfer taxes;
    - Fiduciary duties;
    - Administrative matters; and
    - Claims of creditors and spouses.

Common issues

- Planning for the future;
- Ethical issues;
- State and local tax issues;
- State law regarding fiduciary duties; and
- Governing documents.

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AVOID VALUATION DISCOUNTS

Valuation discounts

- Transfer tax imposed on "fair market value" of asset.
- Willing buyer / willing seller.
- Features justifying discounts:
  - Fractional interests in property
  - Minority interest in an entity
  - Restrictions on transfer

Valuation discounts

- Discounted values can save gift & estate tax.

- Discounted values can increase income tax
  - Reduced depreciation deductions.
  - Increased gain on sale.

- Compare transfer tax "savings" to income tax "cost"

Valuation discounts - Example

- FLP owns assets with a value of: $16,000,000
- Taxpayer owns a 25% interest in FLP.
  - FMV of a 25% interest with discounts: $2,500,000
  - FMV of a 25% interest in FLP assets: $4,000,000
- Taxpayer's other assets worth $1,430,000
- Elimination of discounts:
  - Increases beneficiaries' income tax basis $1,500,000
  - No estate tax cost $ -0-

Valuation discounts

- Redeem high-basis discountable interest.
- Liquidate entity with discountable interests.
- Purchase additional interests in entity.
- Convert entity with discountable interests into entity with no discountable interests.

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Valuation discounts

- Amend entity documents to eliminate features that create discounts.

- Merge fractional interests in property

- Transfer fractional interests in property to an entity or subject them to a co-owners' agreement.

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CAUSE INCLUSION OF TRUST ASSETS IN THE SETTLOR'S ESTATE

Cause inclusion of trust assets in settlor's estate

- Settlor exercises a swap power to recover low basis assets.

- Settlor purchases Trust assets to recover low basis assets.

- Identify settlor's actions that may have triggered Section 2036.

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CAUSE INCLUSION OF TRUST ASSETS IN THE BENEFICIARY'S ESTATE

Cause inclusion of trust assets in beneficiary's estate

- **Distribute assets based on standard.**

- Change trustee to cause beneficiary to have a general power of appointment.

- Exercise a non-general power of appointment to trigger the Delaware tax trap.

- Avoid funding a bypass trust upon a death of a spouse with an outdated estate plan

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CAUSE INCLUSION OF TRUST ASSETS IN A THIRD PARTY'S ESTATE

Cause inclusion of trust assets in a third party's estate

- **Exercise a non-general power of appointment in favor of an elderly or ill family member.**
- Exercise a non-general power of appointment in favor of spouse who leaves the property to the other spouse.
- Add or change beneficiaries.

CHANGING OWNERSHIP OF SPOUSAL ASSETS TO ACHIEVE A NEW INCOME TAX BASIS FOR APPRECIATED ASSETS AND TO PRESERVE THE INCOME TAX BASIS OF "LOSS ASSETS"

Changing ownership of spousal assets

- Spouses exchange assets, with appreciated assets received by spouse with a shortened life expectancy while full basis assets and loss assets are received by other spouse.
- Spouses living in a C/P state can partition C/P assets with appreciated assets received by spouse with a shortened life expectancy while full basis assets and loss assets are received by other spouse.
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AVOIDING IMPOSITION OF THE 3.8% NIIT

ADDRESSING LIFE INSURANCE POLICIES AND INSURANCE TRUSTS THAT ARE NO LONGER NEEDED

Addressing life insurance policies and life insurance trusts that are no longer needed

- Surrender the policy (by the insured, ILIT, or other owner)
- Sell the policy to a third party.
- ILIT transfers policy to grantor-insured.

TURNING OFF GRANTOR TRUST STATUS TO AVOID UNNECESSARY WEALTH SHIFTS AND TO FACILITATE INCOME TAX PLANNING

Turning off grantor trust status

- Release swap power;
- Release power to add beneficiaries;
- Change trustees;
- Relinquish or limit a "revolving door" power;
- Relinquish power to distribute income to grantor's spouse;
- Use trust principal to pay life insurance premiums

CURING ESTATE PLANS

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