Estate Plans Reconsidered with New Tax Rates

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Abstract: When avoiding estate taxation was the primary objective of the trust, the trustee with discretionary control over income might not distribute income to a beneficiary if the income was unlikely to be spent. Making distributions to a beneficiary who would keep the income would defeat the purpose of the trust to shelter funds from estate taxation. That dynamic may be altogether changed by the expanded estate tax exemption and higher income tax rates. Now it's often better to distribute income to the trust beneficiary to avoid the greater tax costs incurred when the highest tax bracket applies to the trust.

In the past, the federal estate tax rate has been as high as 55 percent, and had settled in at 45 percent before winding up at 40 percent in 2013 as a "permanent" rate. On the other hand, long-term capital gains formerly taxed at 15 percent are now taxed at 20 percent for joint filers with taxable incomes of more than $457,600. The tax cost rises further if the 3.8 percent Medicare tax applies, which it would for certain types of net investment income for joint filers with modified adjusted gross income of more than $250,000. The total tax freight may be even greater when state income tax rates are considered. While the estate tax rate is still substantial (and even more so when a state estate or inheritance tax rate is in the mix), the large, indexed exemption, now set at $5.34 million per person, applies to far fewer decedents than formerly had been the case. Conversely, the higher income tax rates now in place require greater attention to be paid to the income tax implications of estate planning techniques.

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Tax Trade-offs under Former Law

When the estate tax exemption was much less than the current amount, it was frequently the case that a "credit shelter trust" was the foundation of an individual's estate plan. This form of trust, which may have been called a bypass trust or a nonmarital trust or any of several other names, was designed to meet the same objective for a married person: to be funded with assets equal in value to the applicable estate tax exemption in the year of death. For example, consider a married person who had a nonmarital trust funded with $2 million of assets following his death in 2008 when the federal estate tax rate was 45 percent. Any future growth in the value of those assets would be excluded from the estate of the surviving spouse for estate tax purposes. However, for income tax purposes, the basis of those assets funding the nonmarital trust would be established upon the death of the spouse who dies first. Any gain in value upon a subsequent sale of a trust asset would be subject to capital gains tax. The gain realized by the trust would be the same as it would have been if a given asset were transferred from the decedent to the surviving spouse and sold by the spouse. However, assets held by a surviving spouse would receive a step-up in basis to their fair market value upon the death of the spouse (if such assets qualify, i.e, they're not income in respect of a decedent, such as investments held in an IRA or qualified plan). In contrast, assets held by the nonmarital trust maintain the same income tax basis after the death of the surviving spouse. The step-up applicable to assets that have grown in value is made available by legislative grace: if the asset is includible for estate tax purposes, as upon the death of the spouse who dies first, the step-up is permitted. By virtue of being excluded from the surviving spouse's estate when held in the nonmarital trust, no step-up is allowed.

Even if an asset were subject to a substantial capital gains tax upon being sold by the trust or its beneficiary, in many instances that cost would be much less than the estate tax that would have been incurred if owned by the spouse, rather than the trust. The trade-off of incurring income tax cost to achieve estate tax savings was acceptable when the prospect of future estate taxation seemed likely because the exemption was lower, estate taxes were higher, and capital gains rates were lower.

New Rates, New Dynamics

The greater estate tax exemption now available relieves many individuals from the need to design their estate

plans in the same way as had been the case with lesser estate tax exemptions. Planning strategies will vary more than had been the case when the estate tax exemption was far less than its current value, and two-trust wills with a nonmarital and marital trust were frequently invoked. Suffice it to say that a smaller part of the population will have classic two-trust wills simply because the exemption is both very substantial and apt to increase because it is indexed for inflation. Wills with disclaimer trusts will still be utilized, some clients will rely on portability, and others may pay more attention to state estate taxes or nontax issues in their estate planning.

Nonetheless, there are many funded nonmarital trusts in place for widowed individuals that might be reconsidered, given the current state of the estate, gift, and income tax laws. Should these trusts be maintained? Suppose that the widowed spouse who is the beneficiary of the trust is unmarried, but has a gross estate that would be well under $5.34 million, even if the trust were terminated and all of the trust assets were distributed to that beneficiary. In that case, putting aside other considerations, terminating the trust could provide a major tax benefit for that spouse's beneficiaries. Specifically, all of the distributed assets would qualify for a basis step-up at the spouse's subsequent death. Upon the spouse's death, his or her children would be able to sell all of those assets without incurring any capital gains tax. That prospect would be welcome to any of that spouse's heirs, and most welcome to those heirs who are in the highest income tax bracket, are subject to the 3.8 percent tax, and reside in a state with high state and local taxes.

Should the Nonmarital Trust Be Terminated?

What factors should be evaluated in deciding whether to terminate a nonmarital trust? To begin with, the trustee must have the discretion, per the terms of the trust, to distribute all of the trust assets and thereby end the trust. If that can be done, the trustee will require that both the current beneficiary, typically the widowed spouse, and the remainder beneficiaries, typically the couple's children, must execute releases so that the trustee may terminate the trust without any concern regarding future liability.

In many cases, the termination can occur because the spouse and the children are on the same page with regard to the tax benefits the children will enjoy in the future. The chances for success are also enhanced if the trustee and the beneficiaries view the trust as existing only (or mostly) to reduce future estate taxation. In addition, if the trustee will continue to invest the funds distributed for the beneficiary, that continuing relationship helps to facilitate a change of ownership.

However, the termination of the trust may not occur so readily if other circumstances pertain. The trust's terms may not accommodate an early ending to the trust. The remainder beneficiaries may be unwilling to consent to a trust termination because of concerns about the welfare of the current beneficiary, their own interests in a future distribution, or both. If the current beneficiary is the parent and the remainder beneficiaries are the children, the prospective tax benefits of termination may be outweighed by personal concerns. Perhaps the parent has remarried, or is contemplating remarriage. Maybe the parent spends money too freely in the opinion of the children. Or, it could be the case that the parent and the children have no conflicts, but the parent may need the financial management that the trust provides. While the trust may have been initiated to save money on estate taxes, it may have assumed greater importance for its nontax value as a means of managing funds for an elderly person who benefits from the trust arrangement.

Trust Distributions and Income Tax Planning

It is also possible that major distributions of principal could be made from the trust, short of the total distribution that would occur upon termination. Once again, the trustee should be mindful of the trust's standards governing principal distribution and should consider how the remainder beneficiaries may view the distribution, apart from its prospective tax benefit. Distributions could be made on a selective basis, with investments having a relatively low basis distributed and investments having a relatively high basis maintained in the trust. Of course, the investments held by the trust may turn over periodically, and over time there may not be many low basis assets. Another thought to consider is that the need to compare the tax brackets of the trust and its current beneficiary is even more critical, after the changes made to the tax law as a result of the American Taxpayer Relief Act of 2012 (ATRA 2012). Income earned by the trust and not distributed to the trust beneficiary is taxed at the highest income tax rate of 39.6 percent for trusts with taxable income of more than $12,150 in 2014. In addition, when the top bracket

applies, the 20 percent long-term capital gain rate also applies to that portion of the gain above its taxable income of $12,150, and the 3.8 percent Medicare tax applies to the lesser of the trust's net investment income or the amount by which its adjusted gross income exceeds $12,150. Thus, everything else being equal, a trustee who has discretion to do so, may find it preferable to distribute more investment income to the beneficiary than to accumulate it in the trust. That preference to distribute income will be accentuated when the trust is no longer necessary to avoid estate taxation. When avoiding estate taxation was the primary objective of the trust, the trustee with discretionary control over income might not distribute income to a beneficiary if the income was unlikely to be spent. Making distributions to a beneficiary who would keep the income would defeat the purpose of the trust to shelter funds from estate taxation. That dynamic may be altogether changed by the expanded estate tax exemption and higher income tax rates. Now it's often better to distribute income to the trust beneficiary to avoid the greater tax costs incurred when the highest tax bracket applies to the trust. Formerly, that income tax comparison might be neutralized by the overriding objective of avoiding estate taxation. Now, estate taxation may not be a factor at all, and distribution decisions will turn on income tax considerations in addition to determining how much the beneficiary should receive according to the terms of the trust. The need for more careful monitoring of income tax implications will be greater this year as the new Medicare tax and income tax rates from ATRA 2012 are experienced by trustees and trust beneficiaries. ■

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