$1.50 VOL. 37 NO. 14 www.ocbj.com APRIL 7-13, 2014

ORANGE COUNTY BUSINESS JOURNAL

Snell & Wilmer

LAW OFFICES

Estate Planning in 2014

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Exemptions and Rates

On Jan. 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 (ATRA) into effect to avoid the "fiscal cliff," setting the unified Federal gift and estate tax exemption at $5 million, indexed for inflation (expected to increase by $100,000 or more every year). ATRA set the generation-skipping transfer tax (GST tax) exemption at the same inflation-adjusted amount. Estate and gift tax and GST tax are all permanently set at 40 percent rates. For 2014, the gift and estate tax exemption and GST tax exemption have already hit $5.34 million.

While prior changes in the law governing the amount that could pass free of estate tax went as high as $5 million, and then to an unprecedented unlimited amount in 2010, in every case, the taxpayer had to die to claim such estate tax exemption. ATRA provides for a $5.34 million unified exemption from estate *and* gift tax, providing wealthy clients with added flexibility for *lifetime* giving as well ($10.68 million for a couple). Taxpayers who previously exhausted their lifetime gift exemption may now make additional tax-free gifts each year as their lifetime exemption increases, in addition to the annual exclusion amounts of $14,000 per donee.

Portability and Simplifying Estate Planning

ATRA also made "portability" permanent – a great benefit to married couples. If a spouse dies without exhausting his or her lifetime gift and estate tax exemption, so long as the decedent's executor makes the proper election on an estate tax return, the unused exemption amount is credited to the surviving spouse for use during his or her life or at death (the Deceased Spousal Unused Exclusion Amount or DSUE). Any of the deceased spouse's unused exemption at the second death will be combined with the second to die's estate tax exemption to offset any estate tax liability in the survivor's estate.

The combined ATRA gift and estate tax exemption, along with portability, allows many married couples to simplify their estate plan and still avoid estate taxation at their death, if the total estate of both spouses does not exceed $10.68 million (taking into account lifetime taxable gifts).

For couples with less than $10.7 million in net worth, an "all to the other" approach which relies on portability to cover any estate tax at the second death is the simplest approach and is not demonstrably wrong (assuming the spouses do not wish to provide directly for children or other family members, friends or charities). This provides the greatest benefit to the surviving spouse and a second stepped-up basis in assets at the surviving spouse's death. Careful thought is still required to determine how assets should ultimately pass to the next generation after the surviving spouse's death, for example, in trust or outright.

Continued QTIP and Bypass Planning

For couples with less than $10.7 million in net worth who are in a second marriage with children from a prior marriage, the traditional "QTIP" trust may still be a better strategy to ensure that the children of the first-to-die are remainder beneficiaries at the second death. The QTIP trust ensures that assets of the first-to-die ultimately pass according to the wishes of the first-to-die, rather than the wishes of the survivor. The QTIP trust can also be used to provide for other family members, friends, or charities chosen by the first-to-die. There is a risk that the QTIP trust assets could be subject to estate tax at the second death, however, depending on how the survivor uses his or her DSUE amount.

Use of the traditional "bypass trust" at the first death will cause the estate tax exemption of the first-to-die to be allocated to the bypass trust, ensuring that it will eventually pass to the children (or other beneficiaries of the first-to-die) without estate taxation. While assets funded into the bypass trust at the death of the first-to-die will receive a stepped-up basis at the first death, the use of the bypass trust will prevent the adjustment of the basis of the bypass trust assets at the second death.

Couples with a net worth greater than $25 million (and even some with a net worth greater than $10.7 million) will continue to engage in more sophisticated estate planning approaches to transfer wealth to their descendants with as little transfer tax as possible. Grantor retained annuity trusts (GRATS), installment sales to defective grantor trusts (DGTs), private annuities and the like will continue to be employed by the sophisticated wealthy couple.

Planning for Beneficiary Problems

Couples will use continuing trusts for children and grandchildren in an effort to protect the assets from the creditors of a beneficiary, the former spouse of a beneficiary, or from the beneficiary's own spendthrift habits and addictions. Careful drafting is required to achieve these goals. In addition, a trust may be drafted to include the ability to move the situs of a trust from California to friendlier states under the right circumstances. For example, it may make sense to move a trust to Delaware, a state that allows trusts to exist in perpetuity and which does not impose a state income tax on trusts held for beneficiaries who are not residents of Delaware.

The Future of the Law

The transfer tax system has been in flux for more than a decade. ATRA instilled a sense of stability to the transfer tax system. However, provisions of the tax code, including ATRA, are as "permanent" as the ever-changing priorities of the Congress and the President.

In March 2014, the Department of the Treasury released the General Explanation of the Administration's Revenue Proposals for 2015, also known as the "Greenbook." The proposals presented by the Obama Administration seek to limit the estate and GST exemption to $3.5 million, reduce the gift tax exemption to $1 million, and increase the top marginal rate to 45 percent. Portability would exist, but in a modified form.

In addition, the Administration's proposals would limit the availability or efficacy of some of the sophisticated estate planning techniques utilized today by wealthy taxpayers. For example, the proposal would impose a minimum ten year term on GRATS and a maximum term of the life expectancy of the donor. The duration of the GST exemption would be limited to 90 years, limiting the tax favored life of dynasty trusts. Also, if a trust is treated as a grantor trust for income tax purposes, then the grantor will be treated as the owner for transfer tax purposes, eliminating the ability to arbitrage the income tax regime and transfer tax regimes.

The most dramatic proposal in the Greenbook, however, is a change to the annual exclusion rules. Under the current rules, a donor can exclude up to $14,000 in gifts per donee annually, with no limit on the number of donees, so long as the donee has a present interest in the gifted property. The annual exclusion amount is indexed for inflation. There are many gifting strategies utilized by taxpayers to take advantage of the annual exclusion rules, from simple gifting of cash in the annual exclusion amount, to more complex "Crummey" continuing trusts drafted to receive annual exclusion gifts each year. Because there is no limitation on the number of donees, these strategies have been used to transfer significant wealth. For example, imagine a grandmother set up Crummey Trusts to take advantage of the annual exclusion to make a gift of $14,000 to each of her 15 grandchildren. That would be a total of $210,000 in annual gifts – transfer tax free! The proposal seeks to abolish the present interest requirement and focus on a maximum of $50,000 of gifts a donor can make annually – regardless of the number of donees. In the above example, that means that $160,000 would be subject to gift tax in each year such gifts are made or would use the taxpayer's available lifetime exemption.

There is no evidence that the Congress ever intends to adopt any of these revisions. Nonetheless, the fact that the transfer tax regime continues to be a topic of conversation within the Administration provides doubt as to the permanency of the transfer tax regime as enacted by ATRA.

Finally, as discussed above, portability may allow simpler estate planning for some couples, but for others with significant wealth, blended families or unique goals, portability may not be the answer. A check-up with your estate planner may be advised to ensure that your plan takes appropriate advantage of today's laws and cutting edge techniques.

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