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Estate Tax Planning in an Income Tax World

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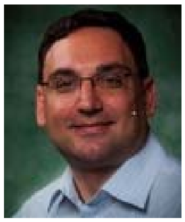

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INTRODUCTION

One notable development in tax-based estate planning over the past 15 years has been the increase of an individual's unified credit and the resulting applicable exclusion amount from $600,000 to potentially over $10.8 million. [3] This amount which can pass free of any wealth transfer taxes [4] is set by statute to continue to increase based upon inflation adjustments. [5] As a result, the federal wealth transfer taxes should continue to apply to fewer estate plans as the years pass by.

[3] Under The Tax Relief Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Act"), a surviving spouse may be eligible to utilize the unused exclusion amount of his or her predeceased spouse. *See* Marc S. Bekerman, *Portability of Estate and Gift Tax Exemptions Under the TRA 2010*, 36 Tax Mgmt. Est., Gifts & Tr. J. 147 (May/June 2011). A full discussion and analysis of the portability provisions is outside of the scope of this article.

[4] For purposes of this article, the wealth transfer taxes to be considered include the federal estate tax, the federal gift tax and the federal generation-skipping transfer tax as each of these taxes utilize the same exclusion amount. However, the state tax implications for a specific client must be considered in any detailed analysis in a particular matter.

[5] §2010(c)(3)(B). For 2015, the exclusion amount is $5.43 million per decedent or $10.86 million per couple. *See* Rev. Proc. 2014-16, 2014-47 I.R.B. 860, §3.33.

Although the increased applicable exclusion amount has been the subject of much commentary, there has been less discussion of the significant changes in the marginal estate and gift tax rates, the marginal income tax rates, [6] the long-term capital gain tax rate, and their collective impact on tax-based estate planning. Perhaps the most striking change is that the difference between the highest estate and gift tax rate and the long-term capital gain tax rate has decreased from approximately 45% to 20% while the difference between the highest estate and gift tax rate and the highest ordinary income tax rate has been practically eliminated. [7] A significant difference between the estate and gift tax marginal rate and the income tax marginal rate will encourage clients whose assets exceed the applicable exclusion amount to take steps to avoid the estate and gift taxes even at the cost of an increased income tax borne by beneficiaries; correspondingly, if the various marginal rates are similar, there is less incentive for such a client to take steps to reduce his or her taxable estate. [8]

[6] The marginal income tax rates for ordinary income govern both personal income tax rates and fiduciary income tax rates. *See* §1.

[7] This article will not consider additional income taxes which may be applicable to certain taxpayers such as the net investment income tax or the alternative minimum tax which could affect the analysis for a particular client.

[8] A basic example is the effect of the basis adjustment at death for property included in a decedent's taxable estate (often referred to as a step-up in basis). When the long-term capital gain rate was 15% and the estate tax marginal rate was 55%, the step-up in basis at death saved a taxpayer's beneficiaries 15% of the capital gain (i.e., the fair market value at death over the basis) at the cost of 55% of the fair market value of the property. As such, there was a significant potential tax savings of making inter vivos transfers of property which was not highly appreciated and even potential savings of such transfers of highly appreciated property.

A full review of the income taxation of trusts and estates as set forth in Subchapter J of the Internal Revenue Code is well beyond the scope of this article. Readers seeking an in-depth treatment of the material are referred to the BNA Tax Management Portfolio on the topic. [9] For purposes of this article, it will be assumed that the reader is familiar with the general principles of Subchapter J, along with the current marginal fiduciary income tax rates. [10] Similarly, a full review of the provisions of the Code containing the rules concerning estate and gift taxation is well beyond the scope of this article. For purposes of this article, it will be assumed that the reader is familiar with the general principles of estate taxation along with the current estate and gift tax rates. [11]

[9] *See* 852 T.M., *Income Taxation of Trusts and Estates*.

[10] *See* §1(e). These amounts are indexed for inflation. *See* Rev. Proc. 2014-61, 2014-47 I.R.B. 860, §3.01.

[11] *See* §2001(c). Although the rates of estate and gift taxes technically are still graduated, the maximum rate is 40% for amounts over $1 million, with the practical effect that the estate, gift (and also GST) taxes are all imposed at a flat 40% rate.

This article will review some of the estate planning techniques traditionally used to minimize estate tax and discuss their applicability and advisability under current law. [12]

[12] Certain implications of the shift in the marginal tax rates were previously discussed in a prior article. *See* Marc S. Bekerman, *Flipping Out — A Review of Some Changes Created by the Reduction in the Highest Estate Tax Rate Below the Highest Income Tax Rate by the 2010 Tax Act*, 36 Tax Mgmt. Est., Gifts & Tr. J. 138 (Sept./Oct. 2011).

SIMPLE INTER VIVOS TRANSFERS

The most basic, and frequent, type of gift is a transfer which qualifies for the annual exclusion. The annual exclusion, currently $14,000 per donor per donee per year for transfers of present interests, has historically shielded most donors from the necessity of filing a gift tax return as well as from the need to use any portion of the donor's unified credit. [13] Like the applicable exclusion amount, the annual exclusion is now indexed for inflation although in increments of $1,000. [14]

[13] If the donor is married and the appropriate election made, the spouses can elect to split all gifts in the current year. *See* §2513. As such, for a married couple, the annual exclusion is effectively doubled. Therefore, the current annual exclusion can shield a donor's gifts of up to $28,000 per donee, per year where the donor is married and the election to split gifts is made on a timely filed gift tax return.

[14] §2503(b)(2). *See* Rev. Proc. 2014-61, 2014-47 I.R.B. 860, §3.35(1).

A donor must file a gift tax return for transfers that do not qualify for the annual exclusion. Usually, transfers do not qualify because they either exceed the statutory limit or are transfers which are not of a present interest. [15] A transferor will utilize his or her lifetime applicable exclusion amount to address the calculated gift tax liability associated with such transfers and will need to pay any amount of the liability which exceeds his or her available exclusion amount.

[15] The donor is liable for any gift tax liability unless the gift requires the payment of such liability by the donee (i.e., a net gift). Rev. Rul. 75-72, 1975-1 C.B. 310; Rev. Rul. 76-49, 1976-1 C.B. 294.

As a practical matter, most donors will never make outright gifts that are not covered by the annual exclusion, especially considering the indexing of the exclusion for inflation and the ability of a married couple to split gifts. In addition, the additional level of protection afforded by the lifetime applicable exclusion will insulate most donors from gift tax liability even for gifts that do not qualify for the annual exclusion. In short, the gift tax will apply to very few taxpayers, and because taxpayers can control the amount and timing of their inter vivos gifts, paying gift tax is usually a choice. [16]

[16] There may be reasons that a taxpayer may wish to incur gift tax liability, for example taking advantage of the gift tax being tax exclusive versus the estate tax which is tax inclusive (i.e., no gift tax is paid on the actual gift tax paid while estate taxes are paid on the actual estate tax paid, a tax on the amount used to pay tax).

Generally the gift tax implications of inter vivos transfers are known prior to the making of the gift and discussed in detail with the client. [17] However, clients must also consider the possible income tax implications of the transfer as well.

[17] In most cases, the only significant question regarding the gift tax treatment of a gift is the valuation of the property interest transferred. For example, if the gift is of an interest in real property, there may be a question of the valuation of the gift if the IRS selects the gift tax return for examination.

Consideration of Basis Adjustment at Death

The gift tax is assessed at the current value of the property regardless of whether the property has a built in gain or loss. Once the property is the subject of a completed gift, future appreciation will not be subject to estate or gift tax in the donor's hands, nor will the donor have any income tax liability on unrealized appreciation at the time of the gift. [18]

[18] For purposes of this discussion, we will assume that the property transferred does not have a built-in loss.

As discussed above, property transferred by a donor during his or her lifetime will not receive a basis adjustment at the death of the donor assuming that the property is not included in the taxable estate of the donor. Instead, the donee will generally utilize the donor's basis in computing his or her capital gain upon disposition of the property. [19] As such, the total appreciation in the property from the time of the donor's acquisition to the time the donee realizes the appreciation will be subject to capital gains tax (i.e., the capital gains tax is assessed on the entire gain both pre-transfer and post-transfer).

[19] There may be adjustments to basis in the hands of the donee to consider which may be applicable in particular cases (e.g., an increase in basis for gift tax paid by the donor).

Example: Client makes an outright transfer of stock with a current fair market value of $5,000,000 in which Client's basis for income tax purposes is $3,500,000. At the time of Client's death, the stock is worth $8,000,000. Client paid no gift tax on the transfer due to his or her available applicable exclusion amount. Client will pay no estate tax on the property because the inter vivos transfer removed it from Client's gross estate. An initial analysis would lead to a conclusion that the client saved approximately $1,200,000 in estate tax assuming that Client would have had no additional applicable exclusion amount available at death [20] and a 40% maximum federal estate tax rate. However, such an analysis fails to consider that the recipient of the property has a transferred basis due to the inter vivos transfer of $3,500,000 as opposed to a "step-up in basis" had the property been included in Client's estate for estate tax purposes. [21] Assuming a 20% long-term capital gain tax rate, the cost of this savings is $900,000 (the gain of $4,500,000 which is subject to capital gains tax upon sale by the recipient). Therefore, the true overall tax savings would appear to be approximately $300,000 in this scenario. [22]

[20] If sufficient time has passed and Client has additional exclusion amount at death which cannot be fully utilized, the true savings would be less than the $1,200,000 since some of the $3,000,000 in post-transfer appreciation would have been shielded by this unused exclusion amount.

[21] Compare §1015 with §1014.

[22] Clearly this example makes several assumptions and the actual tax liabilities for a particular client may vary dramatically based upon actual facts. For example, the recipient of the inter vivos transfer may have capital loss carryforwards which will reduce or eliminate the capital gains tax liability. Similarly, the recipient will incur the capital gains tax only upon a recognition event which may not occur for many years thereby deferring the payment of the tax, or the recipient may retain the property until his or her death which could provide for a change in basis at that time. In addition, the recipient of the inter vivos transfer may not have been responsible for the payment of the estate tax had the gift been made at the

death of Client by a specific bequest or devise under the terms of the Client's estate planning documents (so the person charged with the payment of the estate tax liabilities actually receives the benefit of the reduction in the estate and gift tax while the recipient of the property may incur the entire capital gains tax liability upon sale of the property). On the other hand, the some or all of the realized capital gain may also be subject to the 3.8% tax on net investment income under §1411.

Consideration of Taxation of Future Income Generated by Property

A further possible income tax consideration is that any income generated by the gift, such as interest and dividends from a portfolio, will likely be subject to income taxation in the hands of the donee versus the hands of the donor. [23] This in turn has two implications. First, much like the actual gift itself, the income generated by the property after the gift will be paid to the donee without the donor incurring any additional estate or gift tax. Second, if the donee is in a lower income tax bracket than the donor, there will be an overall income tax savings to the family (of course the opposite result occurs should the donee be in a higher income tax bracket).

[23] There are at least two exceptions to this general rule. One exception is if the gift is made to a trust where the income may be subject to tax either at the trust level pursuant to the rules of Subchapter J or to the grantor if the trust is an intentionally defective grantor trust. Another exception is if the gift is made to a recipient to whom the income will be subject to the "kiddie tax." *See* §1(g), §63(c)(5).

Example: Client has a portfolio which yields annual taxable income of $100,000. If Client retains portfolio while in a 40% federal income tax bracket, Client will have after-tax income of $60,000. If Client then gives this after-tax income to donee, the gift may generate an additional gift tax of $24,000 to be paid by Client. [24] It could cost Client an additional $40,000 in taxable income to satisfy this gift tax liability taking into account the income tax ramification on the gift tax payment. Therefore, it can cost Client $140,000 for donee to receive the amount of $60,000 after income tax. Contrast this result where Client makes a gift of the underlying portfolio to the donee thereby entitling the donee to receive the income directly. Under such circumstance, Client has no further income tax consequences after the gift, thereby saving the additional $40,000 in taxable income noted above. Further, if the donee is in a lower income tax bracket than Client, then the donee will have a greater after-tax income than the $60,000 calculated above. [25]

[24] This result assumes that Client has already made other gifts to the donee which have fully utilized Client's annual exclusion gifts with respect to this donee and that Client has already fully utilized his or her applicable exclusion amount.

[25] There may be non-tax reasons for Client to wish to retain ownership of the portfolio, including cash flow concerns and general desire for control of family assets.

ADVANCED TECHNIQUES

Of course, there will continue to be clients with significant assets for whom tax-based estate planning is essential. This article will now review some of the more common techniques to discuss considerations for each under current tax law.

Gifts in Trust

An applicable exclusion amount in excess of $5,430,000 reduces the need for many clients to engage in transfer tax-based estate planning. Further, an exclusion amount this large (becoming larger every year) provides clients with the ability to make significant inter vivos transfers free of gift tax. It is less and less likely, therefore, that most clients will need to utilize trusts as part of their estate plan for tax purposes. [26]

[26] Of course there are many non-tax reasons why a client may choose to utilize trusts as part of his or her estate plan.

As for those clients who still wish to utilize trusts as part of their estate plans, it is important to note that these trusts have traditionally been drafted so that the trust will not be included in the client's estate for estate tax purposes. Under such a plan, the property in the trust will not be eligible to receive a basis adjustment at the time of the grantor's death. Therefore, any tax analysis of the use of a trust should consider the potential impact of foregoing the basis adjustment at the death of the client.

Drafting Note: If it is expected that there will be no estate tax due upon the client's death, it may be advantageous to include a provision in the trust instrument which will cause inclusion of the trust in the client's gross estate for estate tax purposes. This will have the effect of generating a basis adjustment at death for all property in the trust without any cost to the estate or its beneficiaries. If such an approach is taken, it may be advisable to utilize a string provision which the client can later disgorge should either facts or law change and it is preferable to exclude the trust from the taxable estate (keeping in mind that under §2035(a) the power or interest that would otherwise have caused inclusion must be made more than three years before death in order to prevent the operation of the string sections).

Intentionally defective grantor trusts are often used to enhance the value of the gift to the trust by taking advantage of the grantor's legal requirement to satisfy the trust's ongoing income tax liability. As the grantor trust rules supersede the usual rules governing the income taxation of trusts, the annual income tax consequences of the trust are properly reported on the grantor's personal income tax returns and the resulting income tax liability is the responsibility of the grantor (as opposed to the trust or its beneficiaries pursuant to the rules of Subchapter J). This results in the trust property increasing more quickly, undiminished by the annual income tax liabilities that would otherwise fall to the trust or its beneficiaries and without any additional gift tax consequences to the grantor.

In addition to the general considerations for most trusts discussed above, the use of intentionally defective grantor trusts are also affected by the equalization of the estate tax and income tax marginal tax rates. For many years, the highest marginal gift tax rate was significantly higher than the highest marginal income tax rate for either the trust or its beneficiaries. As such, it was inefficient from a tax perspective for the grantor to make a gift to the trust to reimburse it for any income tax liability. However, with the equalization in marginal rates, it may be equally efficient for a grantor to utilize a non-grantor trust and simply make additional gifts to either the trust or its beneficiaries in amounts sufficient to satisfy any annual income tax liabilities within the grantor's discretion. [27]

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[27] If it is expected that the grantor will not have the ability to make sufficient future gifts free of gift tax liability to compensate the trust and its beneficiaries in satisfying future income tax liabilities, an analysis should be done to determine whether a grantor trust may be the appropriate vehicle for the client's estate plan.

Example: If a donor's income tax bracket is 35%, the use of a grantor trust will result in the trust's taxable income being taxed at a 35% rate when reported on the grantor's income tax return. However, if the beneficiary is in an income tax bracket of 25%, it may be in the best overall financial interest of the family to utilize a non-grantor trust and permit the beneficiary to incur the income tax liability which the donor can then reimburse to the beneficiary in the form of an additional gift when the donor will not incur any gift tax liability on such additional gifts.

Use of Entities to Generate Discounts

The use of entities to generate discounts in valuation has greatly increased since the IRS announced it would no longer seek to apply family attribution rules in valuing transfers for gift tax purposes. [28] Use of entities such as limited partnership interests afforded a client both the traditional benefits of inter vivos transfers for estate tax planning purposes discussed above together with a diminution of value of the property transferred due to discounts for minority interests, lack of marketability, etc. As discussed above, the cost of such savings is losing the step-up in basis at the death of the transferor.

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[28] *See* Rev. Rul. 93-12, 1993-1 C.B. 202.

Example: Client and spouse own 100% of a limited partnership worth $20,000,000 in total with a total basis of $10,000,000. Client wishes to transfer a 10% limited partnership interest to child. At full market value, the pro rata calculation of such transfer is $2,000,000; however, appraisals obtained by client value the transfer at $1,400,000 due to appropriate discounts. Historically, the tax value of the discount could be as great as $240,000, [29] although such calculation does not take into account the expenses associated in making the gift. [30] Under current law, the tax value of the discount may only be $120,000 [31] prior to such additional considerations.

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[29] The calculation of this estimate is the value of discount ($600,000) multiplied by the difference between the highest marginal rate in the estate and gift tax (55%) and the long-term capital gain tax rate (15%).

[30] In addition to the considerations discussed in n. 29 above, the use of entities will often require the client to incur additional expenses such as obtaining the appraisals necessary to support the valuation of the transfers, documenting and effectuating the transfer as necessary based upon the nature of the interest transferred, and preparation of appropriate gift tax returns to meet the adequate disclosure rules to start the running of the applicable statute of limitations. Further, although the IRS does not seek to apply the family attribution rules in valuing the transfer, the IRS has hardly acquiesced to the use of such gifting techniques which may result in additional costs related to defending an audit of the gift tax return and taking any additional steps deemed appropriate by the client.

[31] The calculation in n. 29 above needs to be modified to take into account the current difference between the highest marginal rate in the estate and gift tax (40%) and the long-term capital gain tax rate (20%).

Based upon the foregoing, it is likely that the use of entities for the primary purpose of generating discounts for tax-based estate planning will truly be only for the very wealthy in the future. [32]

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[32] Of course, as discussed in many of the cases, there are numerous non-tax reasons for a client to establish an entity for the management of his or her assets.

Graegin Planning

Potentially deductible payments of interest often arise where the estate has deferred payment of estate taxes over time, usually through one of the following methods:

- statutory deferral permitted under §6161;
- statutory deferral permitted under §6166 for the estate tax attributable to a qualifying closely held business interest; or
- private financing of the estate tax liabilities. [33]

[33] This type of private financing has often involved a "*Graegin* note" based upon the decision in *Estate of Graegin v. Commissioner*, T.C. Memo 1988-477. The ability to deduct the interest payments in general outside of the statutory permitted circumstances will rely upon a number of factors, including whether the interest expense is necessary under the facts and circumstances present. There may be additional impediments to such deductions as well. A detailed discussion of planning in light of *Graegin* is outside the scope of this article. For further discussion, see 832 T.M., *Estate Tax Payments and Liabilities: Sections 6161 and 6166*.

Historically, the decedent's estate would usually look to utilize the interest payments as an estate tax deduction under §2053 and forgo a fiduciary income tax deduction for such payments pursuant to §163. [34] If the estate was entitled to the deferment of payment of estate tax based upon either statutory grounds (e.g., §6166) or administrative discretion (e.g., §6161), the estate generally had no problem in utilizing the appropriate deduction on the estate tax return. However, where the estate borrowed from a lender in order to pay its estate tax liability, the IRS has frequently questioned the availability and amount of an appropriate estate tax deduction under §2053. Although *Graegin* notes have been successfully defended from IRS challenge in several cases, [35] there have been several cases where the estate tax deduction for interest under the loan was disallowed where there was some variation from *Graegin* and its progeny. [36]

[34] Regardless of which deduction is sought, the interest expense must be necessary in the estate administration. *See, e.g., Estate of Stick v. Commissioner*, T.C. Memo 2010-192 (state's deduction for interest payable on note disallowed due to court's finding that estate did not show that it was actually necessary to borrow in order to meet obligations and estate appeared to have sufficient liquidity to meet its obligations).

[35] *See, e.g., Estate of Thompson v. Commissioner*, T.C. Memo 1998-325; *Estate of Gilman v. Commissioner*, T.C. Memo 2004-286. *See also Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. 2009) (a deduction for estate tax purposes was permitted for the interest payable on the loan in the form of a usual "*Graegin* loan" in that the loan was for a fixed term, had a fixed rate of interest and did not permit early payment of the loan).

[36] *See Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. 2009) (deduction for estate tax purposes permitted only for interest actually paid to date on loan which was not in form of usual "*Graegin* loan" in that loan bore floating rate of interest and permitted early payment of loan). *See also Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (Tax Court held loan not necessary and, as such, interest associated with loan not deductible as reasonable and necessary administration expense); *Estate of Stick v. Commissioner*, T.C. Memo 2010-192.

If a note qualifies as a *Graegin* note, the estate will have the option to deduct the interest due and paid on the note on either its estate tax return or its applicable fiduciary income tax returns. However, as analyzed above, it may be in the estate's financial best interest to seek to utilize the deduction on its fiduciary income tax returns. [37] This possible financial benefit, combined with the possible uncertainty as to whether the interest deduction will be allowed on the estate tax return, and in what amount, may encourage planners to anticipate utilizing the deduction on the estate's fiduciary income tax returns rather than on the estate tax return.

[37] The practitioner must consider all applicable federal, state and local taxes and applicable tax rates in making this determination.

One interesting consequence of utilizing the interest deduction on the fiduciary income tax returns is that it may permit an estate planner to forgo many of the requirements of a *Graegin* note since the interest will be deductible on the applicable fiduciary income tax returns so long as the loan transaction was necessary. [38] Similarly, it becomes possible that estates which can demonstrate the need for borrowing and arrange for private funding will also forgo elections under §6161 and §6166 in favor of such arrangements, thereby providing estate planners with additional flexibility in planning for clients with closely held business interests since there would be no need to plan to qualify for relief under §6166.

[38] Certain requirements of *Graegin* notes were to mandate that the interest sought to be deducted on the estate tax return would in fact be paid, especially considering that the examination of the estate tax return might end long before the interest was paid. Utilizing such payments as deductions on the fiduciary income tax returns does not have this complication. Therefore, the note may be able to be

prepaid and have a floating rate of interest, and still have the interest paid each year as a valid deduction on such year's fiduciary income tax return.

CONCLUSION

The 2010 Tax Act had a significant impact on all areas of trusts and estates which will impact practitioners and their clients for many years to come.

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