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Federal Wealth Transfer Tax Reform—Certainty for Now

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The landscape of the wealth transfer tax system has changed—what it mean for your clients.

IT’S BEEN A LONG and very strange journey tracking the federal estate and gift tax laws since 2001. After many years without significant change, the federal estate and generation-skipping transfer taxes were statutorily phased out and repealed by the first of the Bush-era tax cuts. Although many prognosticators never thought full repeal was likely, estate owners fortunate enough to die in 2010 had the opportunity to pass their bounties without wealth transfer taxation. A two-year reform was passed at the end of 2010 giving us an indexed $5 million exemption for gift, estate and generation-skipping taxes with a 35 percent tax rate. This provision once
again was scheduled to sunset at the end of 2012, followed by a return to the wealth transfer tax system that existed prior to June 2001. Some high net worth individuals rushed to make maximum gifts by the end of 2012, certain that Congress would permit the gift tax exemption to return to a mere $1 million. Even those gifts were made with trepidation because of the possibility of a clawback effect in the estate of those who made such gifts if the gift tax exemption was reduced.

Essentially, all of our estate tax planning for the last 11 years was based largely on guesswork due to the uncertain future of the wealth transfer tax system. With the American Taxpayer Relief Act of 2012 (ATRA), we finally have legislation reforming the federal wealth transfer tax system without sunset provisions.

**ESTATE, GIFTS, AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS OF ATRA**

After debate and compromise, the rules moving forward are fairly simple. The key components of the legislation provide:

- **Tax rates.** Congress compromised to set the tax rate of 40 percent. There are lower brackets in the table, but the maximum rate of 40 percent applies to transfers over $1 million. Hence, the first tax payable will be at 40 percent for transfers subject to gift, estate or generation-skipping taxes.

- **Exemption amount (applicable exclusion amount).** The exclusion amount for all three wealth transfer tax systems will be $5 million indexed annually for inflation. Because inflation indexing already applied in 2012, the applicable exclusion amount for 2013 is $5,250,000.

- **Portability of applicable exclusion amount.** The portability provision, which permits the surviving spouse to inherit and use the unused exclusion amount (DSUEA) of the deceased spouse is now a permanent provision. However, the portability provision is limited to estate tax and is not available for the unused GST exclusion. This provision appears to be a no-brainer at first glance, but some considerations in specific estates warrant further discussion (refer to next section).

- **Estate tax deduction for state estate or inheritance taxes.** The deduction for state succession taxes paid is now permanent. This means that the federal estate tax credit for state death taxes paid is repealed. This provision is not much of a surprise because the old credit caused federal estate tax revenue to be diverted to the states.

**PLANNING IMPLICATIONS OF THE NEW WEALTH TRANSFER TAX PROVISIONS**

That the ATRA provisions were made permanent and we can stop warning taxpayers about sunsets and clawbacks is certainly some relief. The higher exclusion amount seems to eliminate more than 99 percent of estates from the federal estate tax. The danger created by this simplicity is that the need for estate planning is more important than ever irrespective of wealth transfer taxes, and estate-planning issues will vary depending on net worth. Remember, there is no “one size fits all” estate plan, and it remains critical to be able to examine fact patterns carefully and explain the implications for alternative methods of transferring wealth.

**NET WORTH UP TO $500,000**

This marketplace has been largely underserved with respect to any significant estate planning. This is unfortunate because smaller estates need to be transferred efficiently. Many heirs might find their inheritances essential. It is estimated that somewhere between 60 and 70 percent of American adults do not have a will. Even if a will has been drafted and executed, it often has not been reviewed, and its implications are generally not understood. Individuals in this category of net worth are likely to be reluctant to spend significant legal fees to execute and periodically review their wills.

It is incumbent on the various members of the planning team to be able to explain and reinforce the provisions of the will. Individuals creating their wills are often unaware that only probate property is distributed by the provisions of the will. Unless the individual is single or a surviving spouse, it is unlikely that he or she will have significant probate if their net worth falls in this range.

Joint property will also create confusion. Married couples often title their property to pass automatically to the survivor or may reside in a community property state that has implications on the transfer of property. Joint property titling is also used by senior family members in lieu of a general power of attorney. If joint titling of financial accounts with survivorship provisions is used with next-generation family members, this can lead to confusion, disappointment and disputes. Estate planners should carefully explain the implications of jointly titled accounts.

Other transfers are often made by beneficiary designation. Often, the titling of property and beneficiary designations are decisions that are made quickly and without much advice
It is estimated that somewhere between 60 and 70 percent of American adults do not have a will.

concerning the estate-planning implications. Members of the planning team should be able to help these individuals with a beneficiary designation audit and determine how the individual has selected to answer the important who, how and when questions that should be answered by anyone transferring property. For example, is it possible that outright transfers have been planned to heirs who have not reached the age of majority (or better yet, the age of maturity).

The key to estate-planning momentum is an individual who is not comfortable with what would happen to his or her estate if they were not here tomorrow. Once the deficiencies of the current estate plan have been explained and addressed, it is possible to have discussions concerning appropriate asset allocation and problems that can be addressed with planning or products solutions such as retirement income planning, life insurance, disability income insurance, annuities and long-term care insurance.

**NET WORTH BETWEEN $500,000 AND $5 MILLION ($10 MILLION FOR MARRIED COUPLES)**

I selected this range somewhat arbitrarily to address individuals with significant amounts of wealth to transfer but who are unlikely to face any significant federal estate taxes.

Individuals in this category have the capability of paying for significant estate-planning advice but, in my experience, will often not see the need for this expenditure. They typically have accumulated this wealth in one generation, maybe enhanced by some modest inheritance. All too often, the federal estate tax has been the focus of too many planners in the past. The enhanced exclusion amounts coupled with portability of exclusion amounts would seem, at first glance, to indicate simple wills if the focus is primarily on the federal estate tax. Important estate-planning considerations for individuals in this range of net worth include:

- **Portability versus exclusion trusts.** The surviving spouse can inherit the unused exclusion amount (DSUEA) of the deceased spouse. It is required that a Form 706 Estate Tax Return be filed for the deceased spouse to transfer the unused exclusion. We’ve had two years experience to tell us that this is often a difficult recommendation, particularly for people at the lower end of this net worth category. There is no Form 706–EZ and this would require a significant expenditure. There are numerous good reasons to continue to use what we used to call the “credit shelter trust” to use the exclusion immediately at the first death. First, it creates a freeze of the growth of the transferred assets exempt from tax. Second, an exclusion amount transferred to a surviving spouse is not indexed for inflation after the first death. Third, the GST exclusion cannot be transferred to a surviving spouse. The exclusion trust could perhaps be created during lifetime in the form of a spousal limited access trust (SLAT). The earlier such a vehicle is created, the greater the freeze of the potential estate appreciation. A careful examination of each fact pattern is necessary to determine whether or not to plan for portability or create the exclusion trust.

- **Impact of appreciation.** The estate of individuals in this category should be examined to determine the potential growth of net worth to determine if the individuals will potentially jump into the next category. Certainly many circumstances such as a family business, private investments, inheritances or even lottery winnings could indicate a change in the level of planning.

- **State estate or inheritance taxes.** The impact of state inheritance or estate taxes should be examined because these could significantly shrink an estate. Some states (Pennsylvania, for example) have an inheritance tax that applies without many exclusions. In the worst-case scenario, the Pennsylvania inheritance tax rate is 15 percent. Many other states fall into the category of decoupled states and apply an estate tax as if the federal estate death tax credit was still in existence. These will have different exclusion amounts depending on the state. For example, New Jersey’s exclusion is only $675,000, while other states have the exclusion as high as the current federal level. It is important to note that the state tax will apply to the decedent in his or her state of domicile, and real estate located in other states is subject to succession taxes in the state where the real estate is located.

- **Gifting strategies.** Individuals at the higher end of this net worth range should have the capability of making some significant lifetime gifts. Perhaps some of the family members have pressing immediate needs for a gift. Gift planning becomes more important as wealth levels near the federal exclusion amounts to prevent or reduce future estate taxes. Gifts will also be very effective if state
inheritance or estate taxes are a concern because the vast majority of states do not have a state-level gift tax.

- **New or existing life insurance.** Life insurance may be indicated for many estate-planning purposes irrespective of an estate or inheritance tax. Perhaps there are family members with special needs. Maybe there is a blended family and life insurance can help provide for specific beneficiaries, such as the new spouse or children from a prior marriage. Perhaps a family business must be transferred and the estate must be equalized between active and inactive children. Life insurance has always been a perfect liquidity tool in this situation. What about existing insurance, perhaps in an irrevocable life insurance trust (ILIT)? Even though the estate may no longer be subject to federal estate taxes, we certainly don’t want to terminate or defund an existing trust without careful consideration. First, we should consider how well the policy is performing. Terminating an effective policy would make no sense, particularly with the currently low alternate investment yields. We certainly could change the existing policy to a new policy or another investment. This might be indicated where there is a single life policy and the insured’s spouse is the income beneficiary of the ILIT. The ILIT might be useful for retirement income planning in this scenario.

- **Asset protection planning.** Asset retitling and/or the use of trusts will be indicated if either the estate owner or any of the heirs have significant asset protection concerns.

- **Planning for nontraditional relationships.** Planning for the circumstances would begin with a consideration of whether or not the relationship is a marriage. In many scenarios, couples will choose not to be married and the federal estate tax marital deduction will not be available. In this circumstance, federal estate taxes will be imposed on estates above the federal exclusion amount. A growing number of states have enacted statutes permitting marriage for same-sex couples. Traditionally, states have solely held the power to determine marital status. This presumably could get more confusing if a couple married in an enabling state moved to a state that statutorily refuses to recognize a same-sex marriage. The Federal Defense of Marriage Act (DOMA) provided that same-sex marriages would not be recognized for federal law. This presumably would include the federal estate tax marital deduction. It is expected that the Supreme Court will rule on this issue in the near future.

**NET WORTH OVER $5 MILLION (OVER $10 MILLION FOR MARRIED COUPLES)**

Planning for individuals or couples in this category must include the consideration of the potential federal estate and generation-skipping transfer taxes. Estate planning will invoke consideration of the traditional techniques to mitigate the effect of federal wealth transfers taxes. Again, the estate-planning process for these individuals should not be focused solely on taxes and should include much of the planning we have already described for individuals in the lower net-worth ranges with the addition of the following:

- **ILITs.** This time-tested planning technique is particularly useful the higher the net worth exceeds the exclusion amount. I don’t particularly favor ILITs for marginal amounts of federal estate tax. But when the potential tax is significant, individuals or couples can use this technique to replace all the wealth lost to federal estate taxes. The new higher exclusion amounts certainly help us with the funding of the ILIT. High net worth individuals are often already using the annual gift tax exclusions. Even if the gift tax exclusion is available, $14,000 per beneficiary may not sufficiently cover all of the gifts to fund a significant premium. The $5,250,000 exclusion amount could be used to cover any otherwise nonexcluded gifts.

- **Low interest rate planning.** Quantitative easing has provided us with historically low interest rates, and this provides the opportunity for high net worth individuals to transfer wealth with unprecedented leverage. Techniques that should be examined to take advantage of low interest rates and/or enhanced gift tax exclusion amounts include intrafamily loans, grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs), and sales to intentionally defective trusts. Through these techniques, the investment chosen for the invested principal of the gift and/or sale needs to exceed the historically low interest rates applicable to the technique. The greater the actual investment return, the more effective the transaction. The interest rate changes monthly and is different for specific techniques.

**THE FUTURE**

Future legislation could, of course, alter the techniques used in estate planning. However, it should never alter the process of examining an individual’s situation and asking the important questions.