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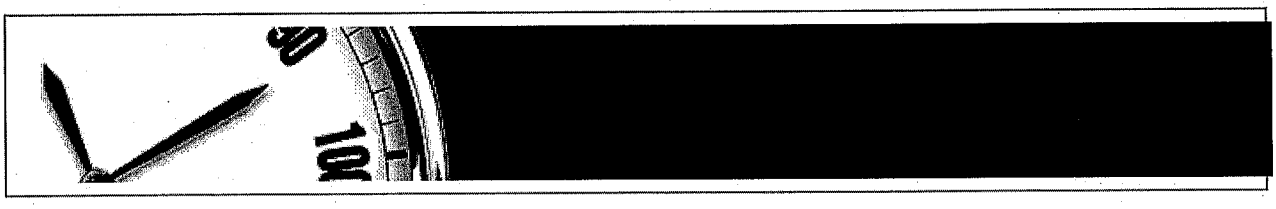
The Beatles and Estate Planning



Musings on the Heckerling conference
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Trusts & Estates
Martin M. Shenkman

"Should 3.8 per cent appear too small,

Be thankful I don't take it all,

'Cause I'm the taxman, yeah I'm the taxman."

One of the themes of many of the presentations at Heckerling this year is the growing importance of income tax planning considerations to estate planning. Many programs have touched on income tax considerations, and others have focused extensively on income tax planning—obviously fostered by the increases in marginal income tax rates to 39.6 percent and the new 3.8 percent Medicare tax on passive investment income.

But the now permanent $5 million inflation-adjusted exemption amount and portability may forever change the perceptions of moderate wealth clients about estate planning. Many of these clients, who comprise the majority of those seeking professional advice about estate planning, may well view "estate planning" as far less important with the fear of the "death tax" eliminated for them. After most new tax acts, our challenge is to master the changes in the law and the modifications to planning techniques to guide clients in planning under the new paradigm. But for the American Tax Reform Act (ATRA), there's a new challenge: We have to educate clients that, regardless of the absence of the estate tax "driver," planning is just as essential. The new "driver" to motivate clients to tend to their planning needs ('cause what would they rather do with their time than talk about complex trusts and dying!) may well prove income tax and the intersection of estate planning and minimization of income taxes. That's easy to "dollarize" and has a more immediate effect than a tax savings at some long distant date of death.

"Income tax is the new hot area," observes Jeremiah Doyle, senior vice president, BNY Mellon, Boston. "The focus of much of planning has to be on income tax. In California, the marginal income tax is now 13.3 percent. Practitioners should refocus clients on the idea that comprehensive estate planning entails integration of retirement planning, insurance planning and income tax planning. Estate planners who can tailor their practices to include more income tax planning will

not only provide a great service to clients in the new tax environment, but they'll generate repeat business for themselves since income tax planning can generate repeat work each year."

"Good morning Mr. Phelps...Your mission Jim, should you decide to accept it . . ."

. . . but, hopefully, this client education process will not prove to be Mission Impossible.

The following is a peppering of some of the myriad of income tax-related planning ideas gleaned from the past three days of Heckerling, with comments from Jeremiah Doyle, senior vice president, BNY Mellon, Boston; Peter Culver, senior director, BNY Mellon, New York; and Ed Mooney, senior wealth strategist, BNY Mellon, New York. And yes, for the sake of transparency they bought me breakfast!

Holding on to Lower Rates

The effective date on the tax rate changes and the 3.8 percent surtax is for tax years beginning after Dec. 31, 2012. This opens opportunity for estates that have a fiscal year, or for 2012 decedents for which you can elect a fiscal year, to defer the application of the higher rates.

If the decedent died in December 2012, choose a Nov. 30 tax year so that the first tax year will be Dec. 1, 2012 through Nov. 30, 2013. The tax rates for 2012 with a lower marginal rate and no 3.8 percent Medicare tax on passive income will apply. Make the election on a timely filed income tax return.

This favorable result can be enhanced in several ways:

- Avoid distributions during that year, since these would pass income out to the beneficiaries who may be subject to the new higher rates. Instead, if the income is retained in the estate, it will be taxed to the estate at 2012 rates sans the 3.8 percent tax. If a beneficiary needs cash urgently to purchase that new Ferrari 458 Italia (in red, of course!), loan the funds instead.
- If the decedent had a revocable trust, bring that under the favorable tax umbrella as well. The executor and the trustee of a qualified revocable trust may elect to treat the trust as part of the estate for income tax purposes. This election may prove advantageous because it may permit the trust to obtain several income tax benefits, which, but for making this election, would only be available to the estate. Pertinent to the planning above is the option to choose a non-calendar fiscal year for income tax purposes. A trust that may qualify for this treatment is one in which the decedent held a power to revoke, such that the trust corpus is included in the decedent's estate. This includes the commonly used revocable living trust. The election once made continues until the trust and estate have distributed all assets. If a federal estate tax return is filed, the election continues until two years following death, or if later, until the final determination of the federal estate tax liability. Treasury Regulations Section 1.645-1(f)(2). The election is made by filing Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." Income tax is calculated on the combined income and deductions of the estate and all electing trusts.

Plan Trust Distributions

Clearly planning for trust distributions—projecting the varying income tax consequences of retaining or distributing—will be an important part of planning.

With the compressed trust income tax rate, in which the maximum rate of 39.6 percent, plus an additional 3.8 percent tax on dividends and capital gains is hit at only $11,950 of income—this will be a big issue. "Many beneficiaries will be below this threshold," notes Culver. But alas, nothing is ever quite simple. If the trust is generation-skipping transfer tax-exempt, the distribution will waste that benefit. While an issue may be whether the family is really concerned about the estate tax under the new regime, the family assuredly will be concerned about a spendthrift beneficiary and negating divorce and asset protection benefits by making distributions.

For the high-net-worth client, the calculus is obviously different. BNY Mellon had a conference call last week to begin to evaluate how to address the spectrum of options. "There does not appear to be a default rule. Rather, the trust officers need to be trained to recognize the issue, gather data and discuss the issue on a trust by trust basis," explained Doyle. This will likely require polling beneficiaries as to their income tax status and even as to their wealth level.

A few considerations to planning for these distributions:

- If you have a trust with appreciated property, you can make distributions in-kind and make an Internal Revenue Code Section 643(e) to make election at the trust level to recognize gain at trust level. "Don't make the election. Instead, transfer in-kind with carryover basis and the beneficiary can sell the property and time when they recognize gain, and, perhaps avoid the maximum tax bracket and 3.8 percent tax as well," suggests Doyle. So, trustees and beneficiaries will have to coordinate income tax and distribution planning more than before.
- At year-end, if there's distributable net income in the trust, the trustee has 65 days after year-end to make a distribution (say, March 6 of the following year) by making an election under IRC Section 663(b) (page 2, Form 1041). Under this election, an amount paid or credited to a beneficiary within the first 65 days of a tax year can be treated as if paid or credited during the estate or trust's prior tax year. This election might facilitate shifting income to a lower bracket beneficiary/taxpayer, and may also permit avoiding the 3.8 percent Medicare surtax. Treas. Regs. Section 1.663(b)-2(a).

Insurance

"Insurance planning will change. The inside build-up of a life insurance policy for many will have more appeal," notes Mooney. Private placement life insurance and inside build-up will be viable for high-net-worth clients. For many insurance planners, insurance represents a deferral play. Annuity products to avoid the high marginal income tax and the 3.8 percent on the growth may gain in popularity. High cash value life insurance policies will increase in use for the same reason.

Other Considerations

There are a host of other estate-planning- income tax considerations, and no doubt more will keep being brought to light as the ATRA is digested:

- Family limited partnerships and limited liability companies can be transformed into income-focused vehicles to shift income from higher bracket family members to lower bracket family members. However, in contrast to the use many years ago as an income-shifting mechanism, the "kiddie tax" will limit the benefits of this.
- IRC Section 529 plans will be even more powerful because of income tax benefits. A simple child's trust to hold future education gift dollars might see more use, as many wealthy taxpayers who are below the federal estate tax radar screen may opt for simpler trusts than the more complex trusts they would have used before the high exemption became permanent. While the Section 529 income tax benefits will be hard to beat, what if a grandchild doesn't pursue college? What if a grandchild is in private school and funds are wanted for that purpose?
- Coordination of wealth managers, consolidated reporting of assets with different firms and better coordination of all wealth managers and the client's CPA will be important to optimally harvest gains and losses with the higher tax costs clients face.

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