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CHECKPOINT® MARKETING FOR FIRMS SAMPLE ARTICLE:

ESTATE PLANNING

Abstract: *As the gift and estate tax exemption has significantly increased, and the estate tax rate decreased, individual income tax and capital gains tax rates have increased. This means that those who expect to have little or no estate tax liability should shift their focus to strategies for reducing income taxes. Fortunately, many estate planning strategies are available that can help reduce income taxes. This article discusses some of these strategies, with a sidebar looking at one in particular: the estate defective trust.*

Adapting to the times

Estate planning focus shifts to income taxes

Until recently, estate planning strategies typically focused on minimizing federal gift and estate taxes, with less regard for income taxes. Today, however, the estate and income tax law landscape is far different. What does this mean for estate planning? For many people — particularly those who expect to have little or no estate tax liability — it means shifting their focus to strategies for reducing income taxes.

Changing estate tax law

For many years, the combination of relatively low estate tax exemption amounts and high marginal rates could easily devour more than half of an estate's value. Popular estate planning techniques often had income tax implications, but in general any income tax consequences were eclipsed by the estate tax savings.

Now that has changed. For one thing, since 2001, the federal exemption has grown from $675,000 to $5.43 million. And, unlike before 2013, the exemption isn't scheduled to drop in the future. In fact, it will continue to gradually increase via annual inflation adjustments. Estate tax rates have also decreased significantly, from 55% to 40%. And the 40% rate has no expiration date.

For many people, this new gift and estate tax law regime means federal gift and estate taxes are no longer an issue.

Income tax matters

At the same time that potential gift and estate tax liability has disappeared for many, individual income tax rates have increased. In 2001, the top federal income tax rate was 39.1%, substantially lower than the top federal estate tax rate of 55%. Now the top income tax rate has grown to nearly as high as the current top estate tax rate.

Taxpayers with taxable income of more than certain annually adjusted levels (for 2015, $413,200 for single filers, $439,000 for heads of households, $464,850 for joint filers and $232,425 for separate filers) are now subject to a 39.6% marginal rate.

Capital gains rates also have increased. Currently, the top rate is 20% (up from 15%) — 23.8% for taxpayers subject to the Affordable Care Act's 3.8% net investment income tax (NIIT). It applies to certain net investment income — including dividends, taxable interest and capital gains — earned by taxpayers whose modified adjusted gross income tops $200,000 ($250,000 for joint filers, $125,000 for separate filers). The NIIT thresholds aren't annually adjusted.

Fortunately, many estate planning strategies are available that can help reduce income taxes. Consider the family limited partnership (FLP). A properly structured and operated FLP allows parents to shift income to children or other family members in lower tax brackets by giving them limited partnership interests. But watch out for the "kiddie tax," which can undo the benefits of income shifting if you transfer FLP interests to dependent children under the age of 19 (age 24 for certain full-time students).

"... from an income tax perspective, there's an advantage to retaining appreciating assets until death rather than giving them away during your lifetime."

Tax basis planning

The heightened importance of income taxes also means that there may be an advantage to holding assets until death rather than giving them away during your life. If you give away an appreciated asset, the recipient takes over your tax basis in the asset, triggering capital gains taxes should he or she turn around and sell it.

When an appreciated asset is inherited, on the other hand, the recipient's basis is "stepped up" to the asset's fair market value on the date of death, erasing the built-in capital gain. So, from an income tax perspective, there's an advantage to retaining appreciating assets until death rather than giving them away during your lifetime.

For those with large taxable estates, however, this advantage may be outweighed by estate tax concerns. From an estate tax perspective, it's preferable to remove appreciating assets from your estate — through outright gifts or contributions to irrevocable trusts — as early as possible. That way, all future appreciation in their value will be shielded from estate tax.

If your net worth is safely within the estate tax exemption, retaining assets until death will minimize the impact of built-in capital gains on your heirs. Alternatively, if you want to share your wealth with your children or other family members, consider using an estate defective trust, which provides current income to your beneficiaries without removing the trust assets from your estate. (See the sidebar "Have your cake and eat it.")

Charitable planning

Higher income taxes can also have a big effect on charitable giving strategies. If your estate plan includes charitable bequests, for example, it makes sense to fund those bequests with assets that otherwise would generate income in respect of a decedent (IRD).

IRD is income that a deceased person earned but never received, such as IRA or qualified retirement plan distributions. Unlike other inherited assets, which are income-tax-free to the recipient, IRD assets can trigger a significant tax bill. But you can avoid these taxes by donating the assets to charity.

If your estate is within the exemption, it's preferable to make charitable gifts during your lifetime. This is because, if you have no estate tax liability, charitable bequests won't yield any tax benefits. But lifetime donations can generate valuable income tax deductions.

Have your cake and eat it

Intentionally defective grantor trusts — also known as income defective trusts (IDTs) — have long been a popular tool for reducing estate taxes. These trusts ensure that assets are removed from your estate while the trust income remains taxable to you.

If, however, your estate is well within the $5.43 million gift and estate tax exemption — so that you're more concerned with reducing income taxes — you might consider an estate defective trust (EDT).

An EDT is essentially the opposite of an IDT. It's designed so that the trust income is taxable to your beneficiaries while the assets remain in your taxable estate. From an income tax perspective, an EDT provides two significant benefits.

First, you can use it to shift income to beneficiaries in lower tax brackets, reducing your family's overall tax burden.

Second, it allows you to share some wealth with your beneficiaries now without losing the benefits of the stepped-up basis at death.

Identifying the right estate planning strategies for you and your family is in part a matter of running the numbers.

Do the math

Identifying the right estate planning strategies for you and your family is in part a matter of running the numbers. Projecting your income and estate tax liabilities — including state as well as federal taxes — will help you determine whether it's better to focus on reducing estate taxes or income taxes.

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