TAX AND WEALTH ADVISOR ALERT: IRS PROVIDES RELIEF FOR SURVIVING SPOUSE TO ELECT PORTABILITY

2010, as part of the Job Creation Act, Congress allowed a surviving spouse to utilize a previously deceased spouse's unused estate tax exclusion. This planning technique is known as "portability." In 2012, as part of the American Taxpayer Relief Act, portability became permanent (or as permanent as any federal statute can be). One of the requirements for portability is that the first spouse to die (the "decedent spouse") needs to file a Form 706 estate tax return and elect portability, prior to death; based on the value of the estate, filing an estate tax return would not otherwise be required. In other words, if the first spouse to die did not file a 706 prior to death, portability is lost.

At least that is what planners thought until the IRS issued Revenue Procedure 2014-18. In that Revenue Procedure, the IRS states that:

1. If a decedent died after 2010 and before 2014,
2. That decedent was a citizen or resident of the US upon his or her death,
3. The decedent's estate was not required to file an estate tax return based on the value of the estate (and taxable gifts), and
4. The decedent's estate did not file a timely return electing out of portability then, prior to December 31, 2014, the estate can file a form 706 and that return will be deemed properly filed.

TAX AND WEALTH ADVISOR ALERT: ESTATE PLANNING AFTER WINDSOR

The federal tax code (the "Code") offers several benefits (and a few burdens) to married couples. In 1996, the United States Congress passed a statute known as the Defense of Marriage Act ("DOMA"). Under DOMA, with respect to any federal statute, a married couple meant a husband and wife; a man married to a woman. Because the Code is a collection of federal statutes, same-sex couples legally married under the laws of a state that provided for same-sex marriage received none of the benefits provided to married couples under the Code.

One of these benefits the Code provides is the unlimited marital estate tax deduction: Under the Code, one spouse can leave an unlimited amount of property to the other spouse without

the imposition of estate tax. Edith Windsor and Thea Spyer were a lesbian couple married in Ontario, Canada in 2007. In 2009, Spyer died and left her entire estate to Windsor. At the time of Spyer's death, both Windsor and Spyer were residents of New York, a state that, at that time, had legalized same-sex marriage and legally recognized same-sex marriages entered into in other states and countries. So, at the time of Spyer's death, under New York law, Spyer left her entire estate to her spouse. But under DOMA, Spyer did not leave everything to her spouse; Windsor could not qualify under the Code as Spyer's spouse as they were both women. Windsor filed her tax return, paid the estate tax and then sued for a refund, arguing that DOMA was unconstitutional. The District Court and the Second Circuit Court of Appeals agreed with Windsor.

The case was then argued in front of the United States Supreme Court. In a landmark decision, the Supreme Court determined that DOMA violated Windsor's and Spyer's constitutionally protected right to equal protection. In essence, the majority opinion held that historically, the definition of marriage is a matter left to the states. In passing DOMA, Congress violated that tradition of state-defined marriage. That departure was due to Congressional bias, and that bias violated the equal protection clause of the US Constitution.

The majority opinion answered this question: If a same sex couple is married in a state that defines same sex marriage as marriage, how is that couple treated for federal purposes (including the tax code)? The answer is clear: The same as any other married couple. But the decision leaves at least two other critical planning questions unanswered: (1) If a couple gets married in a state that allows same sex marriage, but moves to a state that does not, how are they treated for federal purposes, married (consistent with the laws of the state where the marriage took place, or what sometimes is called the state of "celebration") or unmarried (consistent with the laws of the state of domicile which does not allow same sex marriage?) (2) Can a state disallow same sex marriage if, in fact, that disallowance is a violation of equal protection? Hopefully, these questions are resolved in the future.

So after Windsor, estate planners should handle planning for a same-sex married couple in exactly the same fashion they handle planning for a heterosexual married couple. The planner should help the couple build a plan that takes care of the people they care about. The plan will accomplish that goal by getting the right property to the right people at the right time. The plan will ensure that the right people are making the right decisions. And the plan will be allowed to take advantage of the tools provided under the Code to married couples including (but not limited to) the unlimited marital deduction, income tax free transfers, and the ability of an inheriting spouse to treat the transferring spouse's IRA as his or her own.

TAX AND WEALTH ADVISOR ALERT: THE FIRST CLUE TO THE IRS' POSITION AND THE TAX COURT'S THOUGHTS ON MATERIAL PARTICIPATION OF A TRUST FOR THE 3.8% NET INVESTMENT INCOME TAX—ARAGONA TRUST V. COMM'R., 142 T.C. 9 (2014)

Beginning in the 2014 tax year, when a taxpayer's Adjusted Gross Income ("AGI") exceeds a threshold amount, the taxpayer will be subject to a 3.8% tax on his or her net investment income. Net investment income includes income from a business in which the taxpayer does not "materially participate." The section of the Internal Revenue Code (the "Code") dealing with the tax on net investment income (specifically Code section 1411) borrows its critical material participation definition from Section 469 of the Code which deals with the rules on deductibility of losses from passive activities. Under Code section 469, while the rules for measuring the material participation of a human being are straightforward, when the taxpayer who owns an entity is a non-grantor trust, the guidance is conspicuously absent. In fact, Section 1.469-5T(g) of the Treasury Regulations entitled "Material Participation of Trusts and Estates," has no information; it is simply blank. In the regulations to Section 1411, the IRS admits it provides no guidance on material participation by trusts, but states that it hopes to provide future guidance through Regulations promulgated under Code section 469.

So, in essence, when a business is owned by a non-grantor trust, the taxpayer is left without guidance on whether the business' income is subject to the net investment income tax. However, a recent case does provide insight into the IRS' and Tax Court's position on the matter. In *Frank Aragona Trust v. Comm'r.*, the IRS posits that, under Code section 469, a trust cannot materially participate. If the IRS succeeded in that argument, all income from an active business owned by a non-grantor trust would be subject to the 3.8% tax. The IRS also argued, in the alternative, that if the Tax Court held that a trust can materially participate, it is the services that the trustee provides *as the trustee and not the services the trustee provides as an employee of the business* that can be counted towards the material participation standard.

The Tax Court disagreed with the IRS on both counts. It held that a trust can materially participate, and the services of the trustee, whether as an employee of the business or as trustee count towards meeting the material participation standard. This ruling should provide some comfort for taxpayers who utilize non-grantor trusts for estate planning and asset protection purposes to hold businesses, as the Tax Court gives a framework for meeting the material participation standard. At the same time, it should serve as a

cautionary tale that holding business assets in that way might lead to IRS scrutiny and challenge.

TIME FOR THE INCOME TAX TAIL TO START WAGGING THE ESTATE PLANNING DOG

For a long time, estate planners have been focused primarily on the transfer taxes (estate, gift and generation skipping), while minimizing income tax planning when planning with their clients. An example of this would be lifetime gifting. Many an estate planner has pontificated ad nauseum about the power of the gift; if the annual exemption is used, it removes the value of the gift from the donor's estate, and if the lifetime gift exemption is used, it removes the appreciation in the transferred property. But, there has always been an income tax tradeoff to those transfers. The donee receives the property with the donor's income tax basis. Had that same transfer been made at death, the donee would receive the property with a basis equal to date of death value (generally called a "stepped up" basis under the presumption that property will appreciate in value, but for those beneficiaries unlucky enough to receive bequests in 2008 and 2009, they might use the term "stepped down" basis to reflect their reality).

So why did these planning strategists place transfer tax avoidance as a higher priority than income tax planning? A few simple reasons are obvious:

1. Until recently, the transfer tax rate (up to 55% through 2000, gradually lowering since then to its current 40%) was higher than the capital gains rate (which has generally hovered around 15-20%).
2. The amount that could be excluded from the transfer tax system, also known as the estate (or gift) tax exemption was relatively low compared to the net worth of a successful client ($1,000,000 in 2001 growing to $3,500,000 in 2009).
3. The use by a married couple of each of their estate tax exemptions resulted in the first spouse to die's estate tax exemption being left to a credit shelter trust. That property would grow estate tax free after the death of the first spouse, but would not get an income tax basis step up on the death of the survivor.

So what has changed?

1. The rate differential between the transfer tax and capital gains has been dramatically reduced. The transfer tax is 40%; capital gains, when you figure in the impact of the net investment income tax and state tax can be as high as 25-30%. But there is still a differential, so all things being equal, the income tax is still lower.
2. The 2012 Tax Act (AFTA) has made the concept of portability permanent. Without going

too far in-depth on the mechanics of portability, it allows the first spouse to die to transfer not only property to the surviving spouse, but also the right to use the “first” spouse’s estate tax exemption. The impact of portability is that all of the property of the two spouses can get a full income tax step up on the death of the surviving spouse while utilizing both spouse’s estate tax exemptions. But while that gives us an income tax planning tool, it does not make income tax more important than transfer tax from a planning perspective.

3. The real paradigm shift comes from the dramatic increase in the estate tax exemption. In 2014, each spouse can leave $5.34 million (10.68 million working in concert) without the imposition of estate taxes. This will remove millions of people from a world of being concerned about transfer taxes. But, those same people, and their heirs, are subject to capital gains taxes at very low income thresholds. For example, assume Mom and Dad are worth $3,000,000 and are in their late 50s. In the past, the game plan would likely have been to give assets that they believed have high appreciation potential to their two children, both of whom are in their 30s, and each of whom make $100,000 per year. The reason, based on the “rule of 72” is that the appreciation in their hands could have been subject to an onerous estate tax; and in the hands of their children would only be subject to a much lower capital gains tax when the children elected to sell the asset. Or, even better, we could sell the asset to an irrevocable grantor trust, have Mom and Dad retain the income tax exposure on future sales and “leverage” the gift to the children. Now, however, the better move likely is to hold onto low basis, highly appreciating assets to get the income tax step up upon the survivor’s death, with a closer look at the strategy only coming when Mom and Dad’s net worth begins to approach the indexed estate tax exemption. In other words, the planning world is now on its head and waiting is the better strategy than giving for clients whose net worth is under the exemption amount.

At the end of the day, clients will want to seek out advisers who can navigate the world of both income and estate taxes, and can help them build a plan to take care of the people they care about while minimizing the impact of all taxes. No more cookie cutter plans; no more cookie cutter planners.

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