TAX & WEALTH ADVISOR ALERT: TIME FOR THE INCOME TAX TAIL TO START WAGGING THE ESTATE PLANNING DOG

Estate planners should now focus less on transfer taxes and more on income taxes when building a plan that provides for a client's loved ones.

This is a change. For a long time, estate planners were focused primarily on the transfer taxes (i.e., estate, gift, and generation skipping), while minimizing income tax planning for their clients. For example, many an estate planner has pontificated *ad nauseum* about the power of lifetime gifting. If the client utilizes the annual gift exemption, gifting removes the value of the gift from the donor's estate, and if the client utilizes the lifetime gift exemption, gifting removes appreciation from transferred property. But, an income tax tradeoff has always existed. If the client makes a gift during life, the donee receives the property with the donor's income tax basis; if the client makes that same transfer at death, the donee will receive the property with a basis equal to date of death value. This is called "stepped-up" basis and presumes property will appreciate in value. 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 was much higher than the capital gains rate (as high as 55% in 2000).
2. The amount excluded from the transfer tax system, known as the estate (or gift) tax lifetime 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 first spouse to die left assets valued at an amount equal to the lifetime exemption to a credit shelter trust. Those assets would grow estate tax-free but would not receive a basis step-up on the death of the surviving spouse.

So what has changed?

1. The rate differential between the transfer tax and capital gains tax was dramatically reduced. The transfer tax is 40% now, and the capital gains tax can be as high as

25–30% when you figure in the impact of the net investment income tax and state tax. But, a differential still exists, so all else equal, the income tax is still lower.
2. The 2012 Tax Act (AFTA) made the concept of portability permanent. Without going too far into the mechanics of portability, the first spouse to die leaves assets to the surviving spouse tax-free, and portability allows the surviving spouse to utilize both spouses' lifetime exemptions at death. Further, property of the two spouses will receive a full basis step-up on the death of the surviving spouse. Nevertheless, while that gives us an income tax planning tool, it does not make income tax more important than transfer tax.
3. The real paradigm shift comes from the dramatic increase in the estate tax exemption. In 2015, each spouse can leave $5.43 million (10.86 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; however, 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, they would give assets they believed to have high appreciation potential to their two children, both of whom are in their 30s and each of whom makes $100,000 per year. Based on the Rule of 72, the appreciation would be subject to an onerous estate tax in the parents' hands; in the hands of their children, the appreciation would be subject to a much lower capital gains tax when the children elected to sell the asset. Under a better method, Mom and Dad would sell appreciating assets to an irrevocable grantor trust, retain the income tax exposure on future sales, and "leverage" the gift to the children. Now, however, Mom and Dad should hold onto low basis, highly appreciating assets to receive the income tax step-up upon the survivor's death. A closer look at the strategy should be taken only when Mom and Dad's net worth begins to approach the indexed estate tax exemption. In other words, the planning world is now turned 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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