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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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