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MONDAY, MAY 5, 2014

Chicago Daily Law Bulletin®

Volume 160, No. 90

A lurking federal tax law minefield

The American Taxpayer Relief Act of 2012 (ATRA) was signed into law on Jan. 2, 2013, making several of the Bush-era tax cuts permanent. At first glance, ATRA was considered taxpayer-friendly. But upon closer examination, a minefield lurks — not because of potential estate tax but, rather, income tax.

Estate tax levels

Depending on the year of death, a decedent may pass a certain amount of assets free of the federal estate tax (the estate tax exemption). ATRA fixed the federal estate tax exemption, lifetime gift exemption and generation-skipping transfer (GST) exemptions at $5 million, adjusted for inflation ($5.34 million in 2014). In addition, ATRA increased the maximum estate tax rate, gift tax rate and GST rate at the federal level to 40 percent.

ATRA's construction also made portability permanent. Portability allows a surviving spouse to take advantage of the unused portion of the federal exemption of a predeceased spouse, providing the surviving spouse with a larger exclusion amount. Portability is only available to the surviving spouse if an election is made on a timely filed estate tax return. However, portability does not apply to state tax exemptions.

Income tax concerns

ATRA increased the 15 percent capital gain, qualified dividend, interest and other investment income tax to 20 percent for various filers. Further, the Health Care and Education Reconciliation Act of 2010 (2010 Tax Act) imposed a Medicare tax of 3.8 percent.

Despite a lack of federal estate tax, a high income tax can still loom after death and these consequences are significant. Assume a couple had traditional A/B Trusts which created an A Trust (marital trust) and a B Trust (family trust). The income tax concerns arise by virtue of the basis adjustments. Specifically, both the marital trust and the family trust receive a step-up (or step-down) in basis to the fair market value upon the first spouse's death.

The family trust is excluded from the surviving spouse's taxable gross estate and does not get another basis adjustment on the surviving spouse's death. In contrast, the marital trust is considered an asset of the surviving spouse's estate and gets a second basis adjustment on the surviving spouse's death.

Joint trusts are not the answer

With the exemption so high, many practitioners encourage clients to look to "joint family trusts" — a single trust for the benefit of both spouses. Unless a client lives in a community property state, joint trusts are not the answer. Unlike a traditional A/B Trust, joint trusts fail to provide asset protection for the surviving spouse and allow a married couple to pass $5.34 million tax-free to the next generation, whereas a traditional A/B Trust allows each spouse to pass $5.34 million ($10.68 million) tax-free.

A/B Trust with proactive planning prevails

Now that the estate tax exemption is so high, only perhaps 1 percent of the population is faced with a taxable gross estate. Still, our traditional use of the A/B Trusts remains a useful choice to minimize potential estate tax, both federal and state, and to preserve the first decedent's $5.34 million generation-skipping tax exemption.

However, for married couples who don't have taxable gross estates, the increased capital gains tax rates, coupled with the 3.8 percent Medicare tax, pose new tax threats. Almost every client needs to be concerned with a 23.8 percent income tax.

Outright distribution?

In order to mitigate income taxes, some have contemplated an outright distribution to a surviving spouse. Yet despite its simplicity, an outright distribution has many disadvantages, including a loss of asset protection for the surviving spouse and loss of control over the ultimate beneficiary.

Fully funded marital trust?

Another option is to utilize a formula where upon the first spouse's death all of the assets would be allocated to a marital trust. This option secures a basis adjustment to the fair market value at the survivor's death. If the combined estates of a couple are less than the estate tax exemption at the state level ($4 million for Illinois residents) and are not expected to increase, this is a viable option.

Planners should also incorporate flexibility to allow the surviving spouse to disclaim her interest in the marital trust, forcing the allocation to the traditional family trust.

Power of appointment over appreciated family trust assets

Adding specific language to the traditional A/B Trust to address the income tax concerns related to appreciated assets may be the best fit.

To avoid the potential capital gains, Medicare and state income tax in the family trust, a step-up in basis at the survivor's death is required. Stephen M. Margolin, of Chuhak & Tecson P.C., explains the challenge.

"We want to enable our clients to get a double step-up in basis, but not a step-down and, at the same time, minimize any potential federal or state estate tax consequences," he said.

"The solution may be giving a special trustee (an independent, non-adverse trustee or protector) the power to grant the surviving spouse a general power of appointment over particular assets." If we give the surviving spouse a general power of appointment over particular assets, Code Section 2041(a)(2) states those assets are included in the survivor's estate. If the assets are included in the surviving spouse's estate, a basis adjustment is realized.

Margolin explained, "We can limit the general power of appointment pro rata over property with a basis less than a particular level — for example, the power of appointment only applies to assets valued at less than 75 percent of fair market value at the survivor's date of death."

This new tax environment illustrates the paradigm shift in estate planning from estate tax minimization to income tax minimization. Not all clients may require estate tax minimization — but all clients should be concerned with the 23.8 percent income tax.

The new tax regime demands that estate planning attorneys customize estate plans with unique funding formulas based on the individual client's needs to help avoid income tax consequences.

A special thanks to Chuhak & Tecson P.C. law clerk Lorien Schoenstedt for her contribution to this column.

THE BUZZ

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Lindsey Paige Markus, a principal at Chuhak & Tecson P.C., draws on her early career in business, finance and clinically applied neuroscience to communicate with clients and develop creative solutions to fit their estate planning, wealth protection and corporate needs. She has been recognized as one of the 40 Illinois Attorneys Under Forty, a Woman Making an Impact in the Law and an Illinois Super Lawyer Rising Star. She is a collaborative law fellow and is licensed in Illinois and Florida.

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