# ESTATE, GIFT, INCOME AND PLANNING TRENDS FOR 2014

*Authors:*
Mason Brawley
Jim Cashman
Mary Louden
Sandra Sepúlveda

As we approach the end of 2013, we thought it a good idea to summarize some of the significant tax law changes affecting our clients and give some insight as to the different estate planning trends we are seeing among our clients.

## Estate, Income and Gift Tax Law Changes

At the end of 2012, the estate and gift tax laws were in a state of flux. The estate and gift tax applicable exclusion amount (or the "exemption") was scheduled to decrease on January 1, 2013 to $1 million and the estate and gift tax rates were scheduled to increase from 35% to as high as 55%.

Congress and the President acted in early January 2013 to pass the American Taxpayer Relief Act of 2012 ("ATRA"), which permanently (well, as permanent as any tax law) set the estate and gift tax rate at 40% and set the estate, gift, and generation-skipping transfer tax exemptions at $5.25 million in 2013 with annual adjustments for inflation, made "portability" permanent, and made numerous income tax changes as well.

### Estate, Gift, and Generation-Skipping Transfer Tax Exemptions Increased to $5.34 million in 2014

On January 1, 2014, the estate, gift and generation-skipping transfer tax exemptions will increase to $5.34 million. This means that beginning next year, a person may gift up to $5.34 million in assets during their lifetime or, if they make no taxable gifts, die owning assets totaling $5.34 million and pay no gift or estate taxes. The tax rate on lifetime gifts or estates more than $5.34 million will remain 40% (unchanged from 2013). Since the exemptions are now adjusted annually with inflation, we expect the exemptions to continue to increase modestly each year.

### Portability

With increased estate tax exemptions, more estates fall below the exemption amount, resulting in decedents not needing or using all of their available exemption. Under ATRA, married couples (including married same-sex couples) now have the ability to transfer their unused estate tax



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exemptions to the surviving spouse through what is referred to as "portability." The surviving spouse can transfer or "port" any unused portion of the deceased spouse's exemption to be applied to the survivor's estate when they die. By using portability, a married couple will be able to shield up to $10.68 million from estate tax in 2014 ($5.34 million from each spouse).

Prior to portability, in order to utilize the deceased spouse's exemption, estate planners often created trusts requiring the surviving spouse to split the couple's assets into an irrevocable "bypass" or "exemption" trust on the death of the first spouse. With portability, that may no longer be necessary for tax purposes. All of the couple's assets may be passed to the surviving spouse, and the surviving spouse may elect portability and maintain complete control of all the assets during his or her lifetime.

With portability, many clients are able to simplify their estate plans and still fully-utilize both spouses' estate tax exemptions.

## Annual Exclusion Gifts

For gifts made in 2014, the annual gift exclusion limit will be $14,000 (or $28,000 per married couple) – unchanged from 2013. As long as the gifts to each individual remain within the $14,000 limit, there is no gift tax reporting requirement. As a result, annual exclusion gifts continue to be a very popular (and efficient) way to transfer assets.

## Income Tax Changes

Although ATRA broadly extends prior tax rates for most taxpayers, many of our clients in the higher income tax brackets have experienced higher taxes this past year due to the new 3.8% Medicare investment income surtax, the Medicare payroll tax increase, and the higher marginal tax rate.

Surtax on Investment Income - Taxpayers with a modified adjusted gross income over $200,000 (or $250,000 for couples) are now subject to a 3.8% surtax on investment income. Investment income includes interest, capital gains, dividends, rental income, royalties, income from non-qualified annuities and "passive" business income.

Medicare Payroll Tax Increase - The Medicare payroll tax increased an additional .9% for taxpayers with salary and wages over $200,000 (or $250,000 for couples), going from 1.45% to 2.35% once the income threshold is reached.

Increase in Marginal Income Tax Rates - The highest marginal tax rate for ordinary income taxes increased from 35% to 39.6%, and the capital gains

and dividend maximum tax rate increased from 15% to 20%, which applies to taxpayers with taxable income over $400,000 (or $450,000 for couples).

With these changes in the tax law, our clients are finding it increasingly important to also take income taxes into consideration in discussing their comprehensive estate plans.

## Defense of Marriage Act Ruled Unconstitutional

In June, the Supreme Court ruled that a portion of the Defense of Marriage Act ("DOMA") was unconstitutional. As a result, same-sex couples that are legally married (i.e., they were married in a state such as California that allows them to enter into a valid same-sex marriage) are now treated as married for federal tax purposes.

### Estate and Gift Tax Implications

Married same-sex couples are now eligible for the unlimited marital deduction, meaning that transfers between them during lifetime or at death will not be subject to any federal gift or estate tax.

### Income Tax Implications

In addition, married same-sex couples may also now file joint federal income tax returns if the couple is living in a state which recognizes same-sex marriages. In light of these changes, married same-sex couples will need to assess the impact of filing a joint return this April for 2013 as well as filing amended returns for prior tax years in which they were married and for which the statute of limitations remains open.

## Planning Ideas

With these major changes in the estate, gift and income tax law, we find that many of our clients are renewing their interest in estate planning vehicles which provide both estate and income tax benefits. The following are some of the most discussed planning tools:

### Formation of Family Limited Liability Companies ("LLC's")

In this planning technique, parents place income-producing property, such as real estate or dividend or interest producing assets, into a family LLC.

After transferring the assets to the LLC, the parents then gift a portion of the LLC (not the asset) to their children. In this scenario, the children become "silent partners" while the parents retain management and control over the assets in the LLC. Oftentimes, gifts of LLC interests can be discounted since the children will not have control of the assets nor will they have the ability to "market" their LLC interest to third parties. The LLC will also provide protection from a child's creditors or spouse in the case of divorce. The income earned by the LLC will be passed out to the members according to ownership interest, therefore shifting some of the parents' income tax burden to a child who presumably is in a lower income tax bracket.

### Charitable Remainder Trusts

Clients have also showed a renewed interest in charitable remainder trusts ("CRT"). A CRT allows the client to sell highly appreciated assets without paying capital gain tax, while keeping an income stream for their lifetime or a term of years. The CRT will also allow the client to take a current charitable deduction on a portion of the property transferred to the trust. Upon the death of the donor (or the expiration of the term of years), the assets in the trust go to charity.

### Intentionally Defective Grantor Trusts (IDGT)

Another technique our clients have found to be beneficial in addressing their tax concerns is the intentionally defective grantor trust, commonly referred to as an "IDGT." These trusts contain special provisions that allow the trust to be a completed gift for gift tax purposes, but treated as a grantor trust for income tax purposes. The effect of this treatment is that the grantor will pay the tax of the trust for income tax purposes, but the trust will not be included in the grantor's estate for estate tax purposes. By paying the income tax of the trust, our clients, as the grantor of the trust, are effectively able to give an additional "gift" to the trust.

## Charitable Planning

With the increase in income tax rates, especially in California, we are also seeing our clients seeking advice on their charitable gifts. The following are some of the most frequent ways clients are making gifts to charity:

## Outright Gifts

The simplest way to make a donation to a charity is through an outright donation today. The donor can get a current income tax deduction and also remove the assets from their estate for estate tax purposes while getting a chance to see the impact their gift makes while they are alive.

## Wills and Living Trusts

Clients are also including gifts to charity in their estate plan, through a will or living trust. Gifts that will take effect upon a donor's death will not qualify for an income tax deduction, but they may qualify for an estate tax deduction in the donor's estate and can substantially reduce the size of a donor's estate for estate tax purposes.

## Retirement Accounts

Donating to charity using funds from a retirement account is among the most tax-effective methods of making a charitable donation. Distributions from a retirement account to its owner are normally subject to income tax. In addition, retirement accounts are included in the owner's estate upon his or her death, potentially causing estate tax to be due, leaving beneficiaries with less than the full value of the account. Since charities are exempt from income and estate taxes, a charity can be designated to receive retirement account funds, and the amounts they receive will be subject to no taxes. Designating a charity to receive retirement account assets is a win-win for the client who is charitably inclined because the donor can get a larger deduction and the charity can receive a larger donation.

## Charitable IRA Rollover

Prior to 2006, any distributions from an IRA, even if the distribution was immediately gifted to a charity, were subject to income tax. Under current rules, however, individuals who are over 70 ½ are allowed to contribute up to $100,000 each year from their IRAs to a qualifying charity without recognizing the assets transferred to the charity as income. These rules are scheduled to expire December 31, 2013, unless the rules are extended as they have been in the past.

## Gifts of Stock (Appreciated Assets)

Donating appreciated assets, such as stock, may be another smart choice for those who want to make a charitable contribution while optimizing tax benefits. A donation of appreciated stock gives the donor a tax deduction equal to the full value of the stock on the date it is donated. Since the

charity is exempt from having to pay income tax, if it subsequently sells the stock, it gets to keep 100% of the proceeds from that sale.

### Donor Advised Funds

A Donor Advised Fund (DAF) is generally an account maintained by a charitable organization. Donors may set up their own DAF, or make use of a DAF that is already set up for use by members of the general public. Individuals can make donations into a DAF that will ultimately be distributed to one or more qualified charity(ies) of the donor's choice. The donor can receive an income tax deduction in the year the donation into the DAF is made, but the donated funds do not have to be granted to charity in that year. This may be a good option for individuals who want to make a charitable gift this year, but who want time to decide which charity(ies) should receive the donated amounts. While waiting to designate the charities who will receive the donated funds, the money may be invested and allowed to grow.

For added tax effectiveness, DAFs can be used in connection with gifts of appreciated stock or funds from retirement accounts (discussed above).

### Private Foundations

A Private Foundation (PF) is a legal entity that is set up by an individual or group of individuals (such as a family) for the purpose of fulfilling philanthropic goals. Set up properly, a PF allows the donors a deduction for income and estate tax purposes. An important aspect of a PF is that through a PF, family members are allowed to be involved in the process of running the PF. Through a PF, the founders are enabled to pass a culture of charitable giving on to future generations through participation in defining the PF's charitable goals and identifying other charitable organizations to which it will make grants.

## Practical Trends

Finally, not all of the trends we have seen in 2013 are based around the changes in the tax law. The following are many other practical concerns we have seen our clients raise as they complete or review their estate plans:

### Health Care Directives

More and more we see our clients interested in making sure their health care decisions are well documented. In our office we use the California


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Medical Association's form for health care directives and find that most health care providers are familiar with this form. Although this form allows our clients to determine who will make their health care decisions for them if they cannot, what their intent is as to life support and whether they intend to be organ donors, the form is not a DNR (Do Not Resuscitate) nor is it a POLST ( Physician Orders for Life Sustaining Treatment).

The POLST is intended to compliment the Advance Health Care directive particularly for those who are seriously ill or have been diagnosed with a terminal illness. The POLST is virtually a physician's order that has been signed by both the physician and the client and describes very specific methods of life support.

## Durable Power of Attorney for Finance

When a client becomes disabled and is no longer able to handle their day-to-day financial decisions, we have seen a trend of financial institutions wanting a Durable Power of Attorney for finance, even when the assets of the client are in a trust which clearly states who the successor trustee would be in case of disability. Because of this, we are now having our clients sign Durable Powers of Attorney for Finance (DPA for Finance) in addition to a trust. In some circumstances we will also recommend that a client fill out the DPA for Finance for their specific financial institution to be sure that there will be no push back from the financial institution if a disability should occur.

## Trust Certifications

When transferring financial accounts into a trust, financial institutions have traditionally asked for a copy of the trust document. We find that having the client provide a trust certification instead of the entire trust document is a better idea. The trust certification provides the financial institution with the basic information they need without having to provide the entire trust and allows most of the trust provisions to stay confidential. More and more, financial institutions are accepting and even asking for a certification of trust as opposed to the entire trust instrument.

## Ages for Distributions to Children

When asking clients what age they want their children to receive their inheritance we find more and more clients opting for a "lifetime" trust. Clients that are opting for the "lifetime" trust provisions are often concerned that assets their children inherit are protected from the child's potential creditors (such as a child's spouse in a divorce, or a child who has chosen a risky occupation like a doctor, lawyer, architect). The lifetime trust



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provisions allow the child's inheritance to be protected from those creditors for the child's entire lifetime. In most cases the client will allow the child to become the trustee of their own lifetime trust without giving up the protection the trust provides.

## Personal Property Distributions

Distribution of personal effects when someone passes away remains one of the most controversial aspects of administering the estate. We now strongly encourage our clients to write a letter of direction as to where personal effects will be distributed. We like the idea of a letter (versus putting formal language in the will or trust) since the client can easily make changes to the letter without changing their formal documents.

## Funeral Arrangements

In the past several years we have seen an increase in litigation over disposition of a client's remains. As a way to avoid this rather ugly litigation, we now encourage our clients to draft a simple letter of instruction as to their funeral arrangements. In most cases the letter can be as simple as saying the client wants to be buried or cremated, but can be as detailed as the client feels is appropriate.

## Professional Trustees

Statistically, most clients choose a family member as opposed to a professional fiduciary for the role of executor of their will and trustee of their trust. In recent years we have seen a trend toward clients wanting a neutral third party such as a financial institution or private fiduciary acting in those roles. Many of these decisions are the result of clients understanding the amount of work and effort these jobs demand as well as trying to take the burden off one particular family member.

***Please feel free to call any one of our estate planning attorneys for further information***



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