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How do recent updates to estate tax laws impact your future?

Introduction

In 2013, Kiplinger ranked the states with the scariest "death taxes." At that time, New Jersey topped the list, with an estate tax exemption of only $675,000, and with an inheritance tax imposed upon transfers to other than spouses, charities and lineal descendants at a marginal rate of 16 percent. New York and Connecticut were also ranked among the 10 worst states. But in the last three years, much has changed in the area of state estate taxation.

Federal estate taxes have also changed dramatically. The American Taxpayer Relief Act of 2012 (ATRA) was enacted on January 2, 2013. ATRA retained the existing $5 million exemption for estate, gift tax and generation skipping transfer tax purposes and increased the maximum tax rate for all such purposes to 40 percent.

The federal estate tax and gift tax exemptions, now called the basic exclusion amount, is $5 million, indexed for inflation since 2010. The inflation adjusted exemption amount for the estate, gift and generation-skipping tax exemption for 2016 purposes was $5.45 million. For 2017 purposes the amount has risen to $5.49 million.

For many years married couples have structured their estate plans in a way that applies the exclusion amount to the creation of a bypass, an exemption equivalent or a credit shelter trust to benefit the surviving spouse and sometimes other beneficiaries. In many instances, wills have been drafted with formula clauses designed to give the surviving spouse and sometimes children the maximum amount that could pass free of federal estate tax in a trust, often with the remainder upon the death of the surviving spouse passing to the children of the marriage. In light of the substantial increase in the basic exclusion amount, this type of dispositive scheme may produce different results than the testator intended if the instrument was executed at a time when the basic exclusion amount was substantially less than in 2017 ($5.49 million).

Another significant aspect of ATRA are the provisions concerning portability. Portability permits the unused applicable exclusion amount of a decedent to be used by his or her spouse for gift and/or estate tax purposes. (Portability does not apply to a person's (GST) tax exemption.) This means that a person who dies and does not have assets that fully utilize the exclusion amount may transfer the part of his or her exemption that remains unused at death to that person's surviving spouse. (Portability only applies to transfers between spouses.)

These provisions permit a person to use the unused portion of the applicable exclusion amount of only such person's last deceased spouse. The availability of portability may lead some clients to choose not to utilize bypass trusts as a part of their estate planning, but rather to leave their assets outright to their surviving spouse, since the bypass trust concept is no longer necessary to save federal estate tax for a married couple who wish to pass property estate tax free to their surviving children. For others, the retention of bypass trusts in their estate planning will continue to make sense for other reasons discussed later.

It is important to remember that President Donald Trump communicated in various ways throughout his campaign a commitment to repeal the federal estate tax. In general, this position is consistent with the majority of Republicans in Congress, who have also proposed federal estate tax repeal. While there are budgetary and procedural hurdles to overcome

associated with any repeal of the federal estate tax, this subject bears careful monitoring, as a repeal of the federal estate tax would have profound effects upon estate planning for almost all individuals. Open questions remain, including what might happen to the gift tax, and the generation-skipping tax, and whether the so-called "step-up in basis" for assets owned at death would remain the law or be limited or changed in some fashion. It is also possible that any repeal may include a 10-year sunset provision, as did prior efforts to repeal the estate tax.

This update also covers current state inheritance and estate tax laws that apply to the individuals who reside in the metropolitan New York area, Pennsylvania and Florida. Other subjects of interest are included as well.

State transfer tax considerations

Congress repealed the federal estate tax credit for state "death taxes" paid for estates of decedents dying after 2004 and replaced the state death tax credit with a federal estate tax deduction for state death taxes paid. Why is this important?

Most states previously had what were known as "pick up" or "sponge" taxes as their estate tax (although numerous states had inheritance taxes as well). The states that had so called "pick up" or sponge taxes provided that the amount of the state death tax credit reflected on the federal estate tax return for a decedent was the amount of tax due to the state of the decedent's domicile. Those states that provided that their state estate tax was equal to the state death tax credit no longer had a means to collect state estate taxes when the credit for state death taxes was eliminated. As such, various states enacted state inheritance taxes or succession taxes, and some their own state estate tax, in order to continue to have a "death tax" at the state level and the resulting revenue.

The states that enacted these types of statutes were referred to as states that decoupled their state estate tax regime from the federal system. The elimination of the federal credit for state death taxes resulted in various state estate tax and inheritance tax regimes throughout the country. In this section, we examine the current status of state estate tax and inheritance tax taxation in New York, Connecticut, New Jersey, Pennsylvania and Florida.

New York

Effective April 1, 2014, New York increased the amount of a decedent's taxable estate that is exempt from New York estate tax. For many years this exemption amount was $1 million. After January 1, 2019, it will be equal to the federal exclusion amount.

For New York decedents dying between April 1, 2016, and March 31, 2017, the state exclusion amount is $4,187,500. This will increase to $5.25 million for persons dying between April 1, 2017, and December 31, 2018. The marginal New York estate tax rate is 16 percent. Amounts of New York's estate tax paid are deductible for federal estate tax purposes.

New York's new law also contains what has been called a cliff provision. If a decedent's estate exceeds the exemption amount by more than 5 percent, and if those assets go to an heir other than a spouse or a charity, the effect of the exemption is lost and the entire estate becomes taxable for New York purposes. Planning needs to take into account the effect of the "New York cliff" so as to avoid it whenever possible. Often estate plans for a New York couple should include a New York bypass trust to insure that the first spouse to die can take advantage of the New York exemption, which is not portable.

Connecticut

As part of budget legislation in May 2011, Connecticut lowered its estate and gift tax exemption from $3.5 million to $2.0 million, applicable retroactively to estates of decedents dying on or after January 1, 2011, and

to gifts made on or after January 1, 2011. Connecticut has a graduated tax rate system; the tax for estates and gifts of more than $2 million starts at a rate of 7.2 percent with a maximum tax rate of 12 percent on the excess over $10.1 million. In June 2015, the state enacted an estate tax cap of $20 million for resident and non-resident decedents who die on or after January 1, 2016. (A Connecticut resident would need to have an estate exceeding $170 million for the cap to be applicable). The $20 million cap is reduced by taxable gifts made by the decedent or the decedent's estate, or taxable gifts made by the decedent's spouse that are includable in the decedent's gross estate made on or after January 1, 2016.

New Jersey

The New Jersey surprise of 2016 was the stunning development emanating from Trenton in the latter part of the year. A tax bill compromise (which, in part, substantially increased the gas tax) included a provision raising the estate tax exemption from $675,000, previously the lowest in the nation, to $2.0 million effective January 1, 2017, and eliminated the estate tax effective January 1, 2018. This matches Florida's current estate tax regime.

While New Jersey's estate tax will disappear for decedents dying after January 1, 2018, the state continues to impose an inheritance tax. Transfers from a decedent to a parent, grandparent, descendant, children and their descendants, spouses, civil union partners, domestic partners and charities are exempt from the inheritance tax. Transfers by a decedent to any other beneficiaries are subject to the inheritance tax. There is a $25,000 per person exemption for siblings, sons-in-law and daughters-in-law. The tax is imposed at graduated rates ranging from 11 percent to 16 percent, depending upon the relationship of the decedent to the beneficiary. Trenton insiders advise that the 2018 repeal of the New Jersey estate tax may be back on the table depending upon the outcome of the 2017 election, when a new Governor and Legislature will be elected. This subject warrants careful watching.

Pennsylvania

Pennsylvania had a sponge tax or pick-up tax that equaled the credit for state death taxes allowed by federal estate tax law, as discussed above. The state estate tax was eliminated when the federal credit for state death taxes upon which it was based was phased out between 2002 and 2005 and the credit for state death taxes completely phased out.

However, Pennsylvania does still impose an inheritance tax on the value of a decedent's estate transferred to beneficiaries by will or intestacy. A fractional portion of property held by a decedent and one or more other persons jointly with right of survivorship is taxable in a decedent's estate. Inheritance tax is not levied on transfers of assets to certain types of entities, including governmental entities; charitable and fraternal organizations when the property is used exclusively for religious, charitable, scientific, literary or educational purposes; and qualified veterans' organizations.

The inheritance tax is based upon the relationship of the decedent and the person to whom the property is bequeathed. Inheritance tax on the transfer of non-jointly held property to spouses is levied at zero percent. The transfer of property from children 21 years of age or younger to their parent (either natural, step or adopted) is taxed at zero percent. All other transfers to lineal heirs are taxed at 4.5 percent. Transfers of assets to siblings defined as those having at least one parent in common with the decedent related by blood or adoption are subject to tax at 12 percent. Transfers to all other persons are taxed at a rate of 15 percent.

Inheritance tax payments are due upon the death of a decedent and become delinquent nine months after the individual's death. If inheritance taxes are paid within three months of the decedent's death, a 5 percent discount is allowed.

Florida

Florida had an estate tax tied to the state death tax credit like many of the other pick-up or sponge tax jurisdictions. In 2005 with the complete phase-out of the state death tax credit, Florida's state estate tax was eliminated. Most commentators also believe a provision in the Florida State Constitution restricting the amount of estate tax levy would need to be altered in order for there to be a change in Florida's estate tax situation. Thus there has been no state estate tax for the last 10 years, and it is highly unlikely there will be one any time in the near future. Florida also lacks a state income tax, making it one of the most advantageous states in the country from an income and estate tax perspective.

Estate planning considerations

Many of our married clients have structured their estate plans to apply the federal estate tax exclusion amount to create a trust for the benefit of their surviving spouse and children or other heirs. This is generally called a bypass trust, sometimes known as a credit shelter trust, an exemption equivalent trust or a trust of the applicable exclusion amount. Its basic purpose is to create a fund for the benefit of the decedent's surviving spouse and, in certain instances, children or other heirs. The Trust would generally last for the lifetime of the surviving spouse but not be part of his or her estate

for estate tax purposes, thereby optimizing the amount of assets passing to the next generation. Some would conclude that bypass trusts no longer have a purpose, thanks both to the availability of portability and to a 2017 federal estate tax exemption amount of $5.49 million per person, or nearly $11 million for a couple. In light of this, some people prefer to leave all of their assets to their surviving spouse outright and free of trust. But as we shall discuss, a bypass trust may still have utility.

Assets held in a bypass trust for the benefit of the surviving spouse can enjoy increased asset protection, since the bypass trust can be entirely discretionary. If the trust is drafted in a way that gives the trustee the discretionary authority to make distributions to a surviving spouse and children, for example, of either principal or income, the beneficiaries are discretionary and not entitled to mandatory distributions. In that circumstance, the trustee may choose to make or withhold the distributions for beneficiaries depending upon creditor risk at any given time. By having provisions that include discretionary beneficiary interests among various beneficiaries, the trust can minimize the likelihood that a creditor can attach a beneficiary's interest in the trust.

Another advantage: a bypass trust provides much greater assurance that the testator's original intended beneficiaries receive the property from the trust after the surviving spouse's death. With an outright marital distribution, there is always the risk of a remarriage by the surviving spouse after the original testator's death and the possibility that the assets of the testator will not reach the testator's children from a first marriage.

Bypass trusts can also be used to hold special assets that the testator may wish to preserve for future generations, such as a business entity interest, vacation property, farm, ranch or other special family asset.

While bypass trusts can be very effective in accomplishing the purposes described above, it must also be noted that bypass trusts are designed to pass outside of the estate of the surviving spouse. This means that the bypass trust is not a part of the surviving spouse's estate for estate tax purposes. Indeed, the very purpose of the bypass trust is to prevent the assets held in trust from being included in the surviving spouse's estate when he or she dies. The assets held in the bypass trust continue to have the tax basis for income tax purposes, of the assets at the time of the death of the creator of the trust. They do not receive a step-up in basis to the value of the assets at the time of the surviving spouse's death. If a married couples' total assets are less than the value of two combined federal estate tax exemptions, so that use of portability can avoid all federal estate tax, an outright marital disposition can result in a full basis step-up in basis of assets at the second spouse's death, thereby reducing potential federal and state capital gains tax liability upon the sale of assets.

In addition, if the risk of estate tax being due in the surviving spouse's estate is limited due to the size of a couple's combined estate, and there are other reasons why a bypass trust is utilized the capital gain issue mentioned above can be addressed. A bypass trust created for the decedent's spouse can give the spouse beneficiary a general power of appointment. This allows the spouse to direct disposition of the trust's proceeds upon his or her own death. Such a provision would make the trust part of the spouse beneficiary's estate for tax purposes and thus give the assets in the trust a step-up in basis for income tax purposes.

Digital assets:

Many individuals no longer use paper records to handle their financial assets. Often, only electronic records exist. This relatively recent development has created important issues regarding the rights of fiduciaries to obtain a decedent's login information and access digital assets.

In general, wills should now allow a fiduciary to step into the shoes of the decedent account holder in order to access digital assets. It is advisable for clients' estate planning documents to expressly provide for the marshaling,

access, administration and disposition of digital assets, including information on computers, smartphones, tablets, external storage drives or other such devices. It is advisable that estate planning documents, including wills and powers of attorney, provide specific authority from the decedent or principal regarding access to digital assets.

As part of this planning, clients should prepare and maintain current inventories of digital assets, including usernames and passwords, so that such assets can be accessed and readily identified when needed. Care is especially necessary because in some states a user must go online and register with the service provider in order to access documents or assets. Depending upon applicable state law, a person's executor or legal representative may or may not have automatic access to a decedent's digital assets.

Trusts still provide significant advantages

With the increase in the federal estate tax exemption, trusts may be unnecessary for people whose sole purpose is to avoid, or postpone, estate tax. A simple estate plan utilizing outright distributions and relying on portability may meet the needs of some clients. Others, however, will continue to desire the benefits of traditional trusts and other estate planning vehicles, which can serve important non-tax objectives. The good news is that, thanks to ATRA, it no longer is necessary to structure many of these entities according to the requirements of federal transfer tax rules.

Revocable trusts—the traditional staple of certain estate plans—will continue to be used (as will substitutes) in order to avoid probate and "ancillary probate," which is an additional probate process in a state that is not one's primary residence but where one owns real estate, mineral interests or tangible personal property. This will reduce probate-related costs, delays and public disclosure of dispositive provisions. Revocable trusts may direct all property outright to the surviving spouse at the death of the creator of the trust, but they also may create further trusts for the spouse and others.

Because state estate tax exemptions are lower than the federal estate tax exemption in some states, state estate tax exemption trusts may be used to avoid potential state estate taxes, which otherwise could cost some families hundreds of thousands of dollars.

"Dynasty trusts" will continue to be cost-effective vehicles for taking advantage of the $5.49 million GST tax exemption for each spouse, which is not portable. Such trusts allow assets to remain in the family for generations without estate tax. Therefore, trusts that utilize a client's GST tax exemption will continue to be an important part of estate plans. GST tax-exempt trusts are especially useful when assets are likely to appreciate in value, since initial contributions and future growth will remain free of transfer tax for future generations.

ATRA also will enable many couples to create non-traditional "marital trusts" during life or at death, to set aside funds for the surviving spouse while safeguarding the remainder for children or other family members. If the couple's combined assets will not exceed $11 million, there may be no need to structure the marital trust in a way that qualifies it for the estate tax marital deduction. This will add flexibility, permitting, for example, accumulation of income or distributions to other beneficiaries during the spouse's life.

Other significant non-tax advantages of trusts include:

- Providing for the management of assets for beneficiaries who cannot, cannot yet or do not want to manage assets, such as in the case of minors or individuals who are incapacitated
- Taking care of a person's spouse, but also making sure that whatever remains when the spouse dies passes on to one's descendants rather than, for instance, to the surviving spouse's next spouse, or to his or her (rather than your) descendants
- Protecting against future creditors of the trust's beneficiaries, including a child's or grandchild's potential ex-spouse(s)
- Protecting against a person's own potential future creditors, such as protecting a professional's assets against future malpractice claims that exceed his or her insurance coverage
- Protecting assets against Medicaid and similar claims, and providing for persons with disabilities or special needs
- Protecting beneficiaries from being manipulated out of their assets, from giving them away inappropriately or from spending them recklessly ("spendthrift" trusts)
- Providing incentives for beneficiaries to work, or to perform public service, rather than giving them access to considerable sums at too young an age
- Segregating assets acquired prior to marriage from assets acquired during the marriage, and, in some states, limiting spousal rights
- Protecting family assets in instances in which children will not enter into, or may not comply with, prenuptial agreements

- Dealing with community and non-community property in community property jurisdictions, such as California
- Controlling the management and disposition of interests in businesses, real estate, works of art, family compounds and other important assets
- Providing for charity, at present or in the future
- Permitting the present sale of capital assets without having to pay a present capital gains tax by the use of certain types of charitable trusts
- Protecting the assets of persons who are neither citizens nor residents of the United States from American taxes, now and for future generations
- Owning and managing life insurance and the proceeds thereof
- Providing for the funding of buy-sell agreements
- Receiving retirement plan proceeds and administering them appropriately
- Caring for parents or others who need financial assistance
- Accumulating assets for persons under the age of 21 or, if appropriate, beyond
- Permitting funds earned by a trust to be distributed to its beneficiaries, but with the creator of the trust paying all applicable income and capital gains taxes (a "grantor trust"), thereby permitting what are, in effect, additional but gift-tax-free gifts to or for the benefit of the trust's beneficiaries
- Permitting funds to be applied to the benefit of one or more beneficiaries, rather than to be owned by or paid to these beneficiaries
- Accumulating estate-tax-free funds, to be made available to an executor to cover future estate and, if applicable, estate-tax liabilities, perhaps to protect business assets or real estate from having to be sold in a hurry at "fire sale" prices
- Providing "blind trusts" for certain high-level government officials who are not permitted to know how their assets are being invested, to avoid conflicts of interest

Similar to trusts, limited liability companies, family partnerships and C corporations will remain useful tools. Advantages of these tools can include removing appreciating assets from an individual's gross taxable estate, business succession planning, protection against future creditors and perhaps strategic shifting of taxable income or deductions. Moreover, in certain circumstances, it is still possible to transfer minority interests in various entities at a discounted value, thereby leveraging the ability to make gifts that do not exceed exemption amounts. In addition, short-term grantor retained annuity trusts (GRATs) remain viable and attractive options for shifting appreciation tax-free to children.

Accordingly, whether in separate documents or included as parts of wills or revocable trusts, in appropriate circumstances, trusts will continue to be used to fulfill various non-tax goals.

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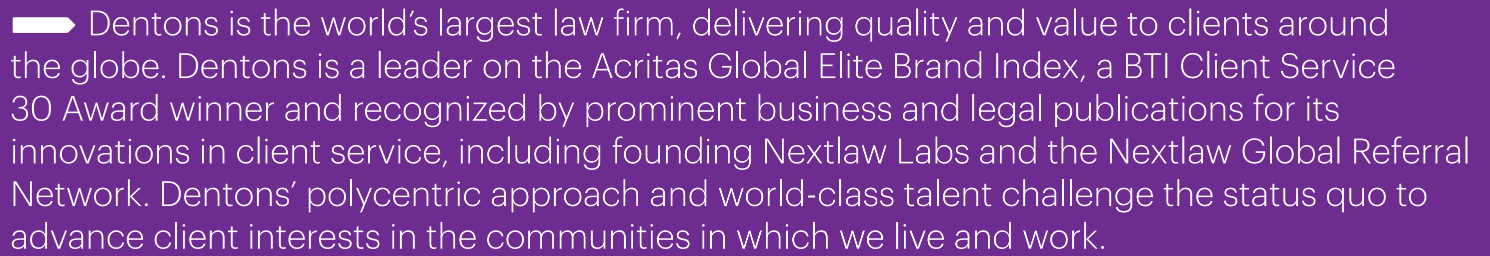
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