INTRODUCTION

The focus of the Fourth Edition of the ESTATE PLANNING STRATEGIST is to incorporate new developments into the planning chapters and related drafting, including the 2012 legislative changes.

I. RECENT LEGISLATION

The 2012 American Taxpayer Relief Act ("ATRA"), enacted at the very beginning of 2013, was lauded as bringing about permanency to the income and transfer tax laws. However, as is the case with any legislation, the law gives us permanency only in the sense that the law does not expire pursuant to its own terms (as the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRAA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRAA) were scheduled to do). The reality is that the Legislature may change the tax law at any time; the President's 2014 budget proposals already contain certain adjustments to provisions that ATRA made "permanent." The budget proposals, among other things, would roll back the Federal estate/gift tax exemption to $3,500,000 (from its current level of $5,250,000 plus inflation) and raise the transfer tax rates to 45% from ATRA's 40%. Thus, even with testamentary planning documents updated to optimize tax consequences in light of current law, there exists the constant threat of changes to the law that may render the documents sub-optimal.

In the current post-ATRA environment, with a $5,250,000 Federal exemption, many taxpayers may be in a position where they have testamentary planning documents in effect that were suitable for prior periods during which the Federal exemption was lower, but that currently would cause unintended tax consequences. Or, taxpayers may be more willing to make taxable gifts in order to utilize the Federal exemption during their lifetimes, but such gifts may also cause unintended tax consequences, specifically with regards to (i) income taxation and (ii) state transfer taxes.

II. INCOME TAXATION

Under ATRA, the top Federal income tax bracket has risen to 39.6%, the top long-term capital gain rate has increased to 20%, and as noted earlier, as a result of the Affordable Care Act of 2010, an additional 3.8% "Medicare contribution tax" is generally being applied to investment income of high bracket individuals and trusts. These increasing income tax rates, when analyzed along with the increased Federal transfer tax exemption and the decreased Federal transfer tax rate of 40%, have rendered income taxation a much larger area of concern within the planning dynamic.

INTRODUCTION

Under Section 1014, property passing either directly to a surviving spouse or to a QTIP for the benefit of a surviving spouse receives an income tax basis step-up to fair market value upon the death of the first spouse and then upon the death of the surviving spouse (assuming the surviving spouse has not gifted away such assets during his or her lifetime). In contrast, property passing into a traditional credit shelter trust that will be excludible from the surviving spouse's taxable estate does not receive an income tax basis step-up upon the death of the surviving spouse. Therefore, in some cases it may be more prudent to have inclusion in the estate of the surviving spouse. And, in all cases, the analysis will be clearer at the death of the first spouse than it is while both spouses are living.

III. STATE TRANSFER TAXATION

Traditionally, a will establishing a credit shelter trust would fund the trust with the maximum amount possible without triggering a Federal estate tax in the estate of the first spouse. Assuming the first spouse does not make lifetime gifts in excess of annual exclusion amounts, that amount is equal to the Federal estate tax exemption in effect upon the first spouse's death. Under current law, that amount would be $5,250,000, and placing that into a credit shelter trust in decoupled states generally triggers a state estate tax payable by the first spouse's estate. In New Jersey, for example, a $5,250,000 credit shelter trust triggers a New Jersey estate tax of $420,800.

This New Jersey estate tax could be deferred or eliminated by having the first spouse leave more assets to the surviving spouse either outright or in a QTIP trust. The surviving spouse can then analyze the transfer tax and income tax consequences of the assets and take suitable action either during lifetime or in his or her will. An example of the combined income tax and state transfer tax considerations described above follows:

Example. H and W live in New Jersey. H owns capital assets worth $2,000,000 and W has no assets of her own. H's will calls for a credit shelter trust to be funded with the maximum amount he can leave without triggering Federal estate tax. H dies, and the credit shelter trust for W is funded with $2,000,000 of capital assets. H's estate pays **$99,600** of New Jersey estate tax. The assets grow to $4,000,000 during W's lifetime, and the assets pass to W's children upon her death. If the capital assets are sold immediately after W's death, the children will be subject to income tax on the $2,000,000 of gain. Using a 20% capital gains rate, the Federal tax will be **at least $400,000**, with

potential additional amounts for the Medicare contribution tax (if applicable) and state income taxation (if applicable).

In contrast, if H leaves the assets to W outright, and then W dies owning the assets (worth $4,000,000), (i) there is no Federal or estate tax due upon H's death due to the marital deduction, (ii) W's estate pays **$280,400** of New Jersey estate tax, and (iii) W's children pay no income tax upon the sale of the capital assets.

Again, in certain cases, estate inclusion in the estate of the surviving spouse will be preferable to exclusion via a credit shelter trust, and in all cases, the determination is more accurately made following the death of the first spouse than while both spouses are still living.

IV. ACHIEVING FLEXIBILITY

How can we plan currently but defer tax-related decisions for the maximum time possible (for example, until after the death of the first spouse)? In order to achieve the desired time deferral, testamentary planning documents should be drafted with as much flexibility as possible. Two such options include (i) disclaimer planning and (ii) "*Clayton*" QTIP trust planning.

A. DISCLAIMER PLANNING

In this scenario, the first spouse leaves assets to the surviving spouse outright, instead of mandatorily creating a credit shelter trust. The surviving spouse then has the ability to disclaim some, all, or none of the assets into a trust for the surviving spouse's lifetime benefit that qualifies for the estate tax marital deduction (a "QTIP-able" trust). The decision as to how much of the first spouse's estate tax exemption to use can then be made by determining the amount of trust assets over which the QTIP election should be made. Thus, the primary advantage of this disclaimer method is that it defers the ultimate tax-driven decisions to a time when the status of the tax law is known, as opposed to when the will was executed.

The disclaimer method, however, does impose a certain affirmative responsibility on the surviving spouse to act (make the disclaimer decision) within nine months of death.[1] In addition, in order to have a valid "qualified disclaimer" for Federal tax purposes, the trust into which assets are disclaimed may not give the surviving spouse the right to direct the beneficial enjoyment of the

[1] Code § 2518(b)(2).