

# Does Income Tax Planning Trump Estate Tax Avoidance? Income Tax Planning When Estate Taxes Don't Matter

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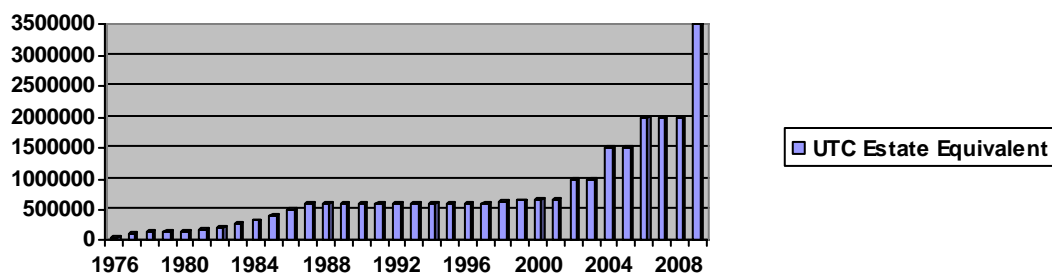
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For decades, estate planning has been largely dominated by desire to avoid a confiscatory federal estate tax. In 1976, the amount a decedent could pass tax-free to non-charitable heirs was only \$60,000. By the early 1980s it had increased to \$175,000. These relatively small exemption amounts meant even middle class Americans had to design their estates to avoid the federal estate tax.

The Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”)<sup>1</sup> effectively began to take the middle class out of the federal transfer tax system by the adoption of a series of reforms, including an unlimited marital deduction and a phased-in unified unified tax credit equivalent to a \$600,000 exemption. However, over time the benefit of a stagnant \$600,000 unified tax credit lost value to inflation.

While not providing an inflation adjustment to the unified tax credit, the Taxpayer Relief Act of 1997<sup>2</sup> provided for a phased-in increase in the exemption to \$1.0 million by 2006. The act also provided for an inflation adjustment for the annual exclusion and included an inordinately complicated estate tax exemption for family farms and businesses.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)<sup>3</sup> provided for even higher tax-free transfers. While elimination of the federal estate tax is highly unlikely, significant estate tax exemptions will probably remain for the foreseeable future, reducing the tax confiscation many clients had anticipated at their death.



These changes mean that fewer Americans than any time in recent history will be subject to a federal estate tax. In 2001, when the federal estate tax exemption was equivalent to \$1.0 million, approximately 2.1% of all decedent estates were subject to a state of federal estate tax.<sup>4</sup> By one estimate, in 2006, less than one percent of all decedent

1 Pub. L. 97-248.

2 Pub. L. 105-34.

3 Pub. L. 107-16.

4 Elizabeth C. McNichol, “Assessing the Impact of State Estate Taxes,” Center on Budget and Policy Priorities, February 18, 2004.

estates will owe a federal estate tax.<sup>5</sup> For the vast majority of Americans, estate planning will no longer be driven by the avoidance of a federal transfer tax. Instead, personal and family concerns and other tax issues will drive the estate planning process.

However, the substantial federal estate tax exemptions will be partially offset by higher state estate taxes. As a part of EGTRRA, Congress replaced the state death tax credit with a federal estate tax deduction.<sup>6</sup> Thirty-eight states used the federal credit as their state estate tax. The elimination will require many states to impose new death taxes - an unpleasant political act. Even if Congress restores the federal state death credit, many states will be reluctant to adopt the higher federal exemptions. As a result:

- X Thirty-eight states which were using the federal estate tax law as the basis of their state estate tax will have to revise their estate tax statutes or incur a significant loss of revenue.<sup>7</sup>
- X Some states will adopt exemptions that are lower than the higher federal exemptions, creating a state estate tax when no federal estate tax is due.
- X Some states will freeze their state death tax as the pre-2001 federal credit, resulting in a top effective state tax rate of 16% (i.e., the top rate for the old federal state death tax credit).
- X Some states could adopt inheritance taxes, with the tax rate being determined by the relationship of the decedent to the heir (i.e., the more remote the heir, the higher the tax rate).
- X Like the federal government did in 1924, more states will adopt a state gift tax<sup>8</sup> to stop the loss of transfer tax revenue through lifetime gifts.<sup>9</sup>
- X The lack of uniformity in state death taxes will add complexity to estate plans. For example, if a person owns property in more than one state, the avoidance of the cost and taxes of ancillary probate will become a greater part of the estate plan.
- X The pressure to Aforum shop@ will increase as taxpayers attempt to move their tax domicile to states like Florida that have lower taxes. Florida cannot amend it=s state estate tax without a constitutional amendment (an unlikely event given the number of retirees in south Florida).<sup>10</sup>

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available at [www.cbpp.org/2-18-04sf.htm](http://www.cbpp.org/2-18-04sf.htm)

<sup>5</sup> See: John Godfrey, "US Senate Endorses Plan to Speed Cut of Estate Tax," Wall Street Journal, March 21, 2003.

<sup>6</sup> Bruce D. Steiner, "Coping with the Decoupling of State Estate Taxes After EGTRRA," Estate Planning Journal, April 2003; Woods, "Decoupling Dilemma, 143 Trusts & Estates 50, April 2004; Howard Godfrey, "The Phaseout of the Federal State Death Tax Credit," The Tax Advisor, February and March 2004; Elizabeth C. McNichol, "Assessing the Impact of State Estate Taxes," Center on Budget and Policy Priorities, February 18, 2004, available at [www.cbpp.org/2-18-04sf.htm](http://www.cbpp.org/2-18-04sf.htm)

<sup>7</sup> For example, Florida in 1999 received almost \$650 million from the credit. Unless other sources of revenue are located, Florida (which has no income tax) could be facing severe budgetary problems.

<sup>8</sup> As of December 31, 2003 only Connecticut, Louisiana, North Carolina, and Tennessee have a state gift tax;

<sup>9</sup> See: Debra L. Stetter, "Deathbed Gifts: A Savings Opportunity for Residents of Decoupled States," Estate Planning Journal, June 2004.

<sup>10</sup> Dean L. Surkin, "The Impact of the Decoupling of State Estate Taxes on a Taxpayer's Choice of Domicile," Journal of Taxation, July 2004.

For most Americans state and federal income tax planning will trump federal estate tax avoidance. This article will discuss some of the income tax planning opportunities of this new environment. As much as possible, we have tried to provide additional research sources for the ideas discussed in the article.

### **Income Tax Planning**

Many planning opportunities have been limited by concerns over the avoidance of a federal estate tax. When estate tax rates reached as high as 60%, while federal income rates topped out at 39.6%, this concern was certainly valid. But these estate tax restrictions will disappear for the vast majority of Americans, whose tax planning strategies will shift from federal estate tax avoidance to state and federal income tax reduction. Among some of the possible opportunities:

Income Shifting. A client who is funding benefits or obligations (e.g., college or support costs) for someone (e.g., a college age child or a parent in a nursing home) who is in a lower income tax bracket should consider adopting approaches by which the ordinary income or capital gains of the client are shifted to the lower tax rate taxpayers. There are a number of methods of accomplishing this task, including:<sup>11</sup>

- Trusts can be created to hold income producing assets with the income being allocated among the beneficiaries based upon the discretionary decision of trustees. These “spray trusts” are discussed in more detail later in the article.
- The transfer of non-controlling interests in flow through entities (e.g., LLCs, partnerships and S corporations) may be used to shift income to lower bracket family members without giving up control over the underlying asset or the family business. The recent IRS assaults on family limited partnerships (“FLPs”) have mainly focused on the estate tax aspects of FLPs. However, for most clients, the federal estate tax issues surrounding FLPs will become moot. FLPs remain an excellent tool for maintaining control of an asset, while the income earned from the asset is allocated to lower bracket family members.
- A business could hire family members to work in the business. However, if the business owner has earned income over the \$90,000 (in 2005), then this approach could create social security taxes which the business owner would not have incurred.<sup>12</sup>

***Planning Example:*** Assume a client has a rental property which produces ordinary taxable income of \$200,000 per year. The client is in the 35% federal bracket, but his five children and ten adult grandchildren are all in an effective tax bracket of 15%. The client places the rental property in an FLP and retains a 2% general partnership interest. Over two years, he transfers the FLP interests to a

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<sup>11</sup>See Westfall and Mair, Estate Planning Law and Taxation, Section 10.02. (WG&L).

<sup>12</sup> i.e., in 2005, above the \$90,000 wage base, the combined employer and employee social security rate drops to 2.9%, a rate savings of 12.4% when compared to the tax rate on earned income below the wage base.

spray trust for his descendants using Crummey withdrawal rights to preserve his state and federal estate tax exemptions. The trust has the right to spray income among his descendants. Using the income tax brackets of the 15 trust beneficiaries, the overall tax on his rental property would drop by up to \$39,200.<sup>13</sup>

Income shifting can also result in changes in the character of shifted income. For example, assume a client is a real estate developer. Because the developer is considered a “dealer” in real estate, income from the developer’s development of real property will generally be treated as ordinary income.<sup>14</sup> If property were initially acquired or transferred to family members who were not developers, sale of the real estate could be treated as a capital gain transaction.

Income shifting may also be used as a method to reduce the phase-out of tax benefits that apply to many higher income taxpayers. For example, the ability to fund a ROTH IRA is phased out for married taxpayers with a modified adjusted gross income of over \$150,000. If the shifting of income took the taxpayer below the limits for any applicable deductions or tax benefits, it could provide an additional benefit to the donor.

Income shifting does carry some risks. For example:

- Clients who adopt income shifting strategies should make sure the transactions have economic substance, do not run afoul of the “assignment of income doctrine”<sup>15</sup> and do not result in the IRS’s reconfiguring the transaction<sup>16</sup> to avoid the evasion of taxes or to clearly reflect the taxpayer’s income. If these doctrines and rules are violated, the client may remain taxable on the income that was supposedly shifted to lower bracket taxpayers.
- In creating such structures, planners should keep in mind the state income tax ramifications of shifting income. For example, many states have begun taxing non-residents on the income distributed from local flow-through business entities. For example, Georgia requires that non-resident owners pay income taxes on the income distributed from some S corporations, partnerships and LLCs.<sup>17</sup> While forum shopping for estate tax and asset protection purposes has been in vogue from some time, clients may also use forum shopping to minimize any state and local income tax liability.
- The client must give up the income. In most cases, income shifting only makes sense if the client is willing to forgo future income and/or the client is already funding a need of a lower bracket taxpayer (e.g., nursing care costs).

Charitable Bequests and IRD. When clients want to make charitable bequests, they should consider funding the charitable bequests with retirement or other assets that

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<sup>13</sup> i.e., \$200,000 per year times the 98% limited partnership interest times the 20% difference in tax rates.

<sup>14</sup> IRC section 1221 provides that capital gain treatment is not available for property held “primarily for sale to customers in the ordinary course of business.”

<sup>15</sup> See *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Clifford*, 309 U.S. 331 (1940); For an excellent discussion of this topic see Westfall and Mair, *Estate Planning Law and Taxation*, Section 10.01[4][a] (WG&L).

<sup>16</sup> IRC section 482.

<sup>17</sup> c.f., O.C.G.A. section 48-7-129.

would have created “income in respect of a decedent.”<sup>18</sup> Because of the current rules on naming beneficiaries of retirement accounts, the client is best advised to bifurcate any IRA account into an account that names a charity as beneficiary and one or more other accounts that name non-charitable beneficiaries.<sup>19</sup> If the client either does not want retirement assets to go to charity or does not have retirement assets, the will or living trust should provide that any charitable bequest first be funded from IRD assets to the extent the estate or trust held or receives such assets.

***Planning Example:*** A client has a desire to pass \$30,000 to a charity at the time of his death. He holds an IRA worth \$25,000. The client could name the charity as beneficiary of his IRA and provide in his will that the estate pay to the charity the difference between \$30,000 and the IRA value at his death. Assume the IRA was worth \$20,000 at death and the client’s only heir is in a 40% state and federal income tax bracket. The passage of the \$20,000 in IRA funds to charity would save the heir up to \$8,000.

**Investment Decisions.** Investments in trusts and estates may change to those that are more tax effective. Net after-tax returns will become a critical part of investment evaluations. For example, fiduciaries will be more prone to use tax efficient mutual funds and capital gain investments rather than those that may be taxed at higher ordinary income rates, particularly when trusts and estate will be accumulating income.

This trend is already evident in the growth of total return trusts. One motivation for total return trusts is the desire to move away from strict definitions of income and principal that tend to distort fiduciary investment decisions. When fiduciaries are free to make the best economic decisions to produce the highest after-tax return, the net return to all beneficiaries should increase. See the later discussion of total return trusts.

It is not just the form of the investment (e.g., stocks or bonds), but also the tax vehicle which holds the investment which may be important. Assuming that the client meets the qualification rules, there are a number of tax-preferred vehicles that can reduce or eliminate applicable income taxes. Among some of the possible planning vehicles for saving income taxes:

- **ROTH IRAs.** Investments in vehicles that are not subject to income taxes are the ultimate winning investment. Clients who qualify to convert a regular IRA to a ROTH IRA should consider doing so before death and bequeathing the ROTH IRA to family.<sup>20</sup>

***Planning Example:*** Assume a terminally ill client has an IRA with \$100,000 in assets. The client could convert the IRA to a ROTH IRA and pass the

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<sup>18</sup> IRC section 691(c). See Sanford J. Schlesinger & Dana L. Mark, “Charitable Estate Planning with Retirement Assets,” Estate Planning Journal, August 2001 and Gary L. Maydew, “How the Courts Interpret Income in Respect of a Decedent,” Journal of Taxation, January 2000.

<sup>19</sup> Sanford J. Schlesinger and Dana L. Mark, “Charitable Estate Planning with Retirement Benefits,” Estate Planning Journal, August 2001.

<sup>20</sup> Bruce D. Steiner, “Eight Reasons to Convert to a ROTH IRA,” Journal of Retirement Planning, May/June 1998; Marvin R. Rotenberg and Mark S. LaVangie, “To ROTH or not to ROTH,” Journal of Retirement Planning, January/February 2004.

ROTH to heirs. Assuming the client has an estate below the federal unified credit exemption equivalent, the ROTH IRA will not be subject to a federal estate tax, and the growth in the ROTH from the conversion date will not be subject to any further income taxes. If the client has an NOL that was going to disappear at death, the tax conversion cost could be reduced by the NOL.

- Education Programs. The code provides that the growth in value of investments in section 529 plans and Coverdale Education Savings Accounts will not be taxable if used for qualified purposes.<sup>21</sup> Parents and grandparents should consider using annual exclusion gifts to provide funds to less wealthy descendants to fund these education programs.
- Medical Savings Accounts. If used for qualified medical purposes, the growth in the value of assets in a medical savings account are not subject to any further income taxation.<sup>22</sup>
- Charitable Remainder Trusts. Client who anticipate that a sales transaction will generate significant tax costs should consider placing the assets in a CRT to eliminate the current tax cost of the sale.

Payment of Fees. For most estate deductions for fiduciary fees will now shift to the fiduciary income tax return. But when a personal representative receives a payment for performing fiduciary functions, the income which is earned is taxable at ordinary income rates as earned income. Unless the personal representative is in the trade or business of serving as a fiduciary, the income is not generally subject to social security taxes.<sup>23</sup>

When the estate is not going to incur a federal or state estate tax, the payment of fiduciary fees does not generate an estate tax benefit, but could increase the income tax burden of the personal representative. In many cases, especially when a trusted heir is going to serve as personal representative, the client should consider making a special bequest to the heir. To assure that the heir does not also seek to obtain fiduciary fees, the will could deny personal representative fees to any heirs who serve as a personal representative. As further protection, the document might provide that the special bequest lapses if the heir is incapacitated or dead (i.e., the chosen fiduciary cannot serve).

The net effect of using this special bequest is that the estate's taxable income that would have otherwise been offset by a deduction for an executor's fee is now taxable to either the estate or the other beneficiaries. If the personal representative is the only heir, this technique will be of nominal benefit.

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<sup>21</sup> Randy A. Fox and William K. Root, "New Dimensions in Education Planning," *Journal of Practical Estate Planning*, August/September 2001.

<sup>22</sup> Stanley D. Baum, "The Advantages of Health Savings Accounts – the Code's Newest Healthcare Arrangement," *Journal of Taxation*, February 2004.

<sup>23</sup> Rev. Rul 58-5, 1958-1 C.B. 322 and *McDowell v. Ribicoff*, 292 F.2d 174 (3<sup>rd</sup> Cir 1961). But see PLR 9107009 where the fiduciary fees paid to an attorney who served as a fiduciary for 12 trusts was considered self-employment income.

## Planning for the Decedent and His Estate

Pre-Mortem Planning. Although death is often an unexpected event, there are cases in which a terminally ill client can plan for the reduction of his or her taxes. For example:

- The losses of a decedent are not carried over to the estate or heirs.<sup>24</sup> Instead, they simply vanish. There are at least three ways expiring losses could be used. First, the client (or persons holding a general power of attorney) could take actions to use any expiring losses (e.g., accelerating taxable income). Second, a married client who files a joint return might have the spouse take pre-mortem actions to create taxable income to offset the soon to expire losses. Third, a surviving spouse who is entitled to file a joint return in decedent's year of death could take post-mortem steps (e.g., accelerating income) to offset the losses.

*Planning Example:* Assume a client has a net operating loss of \$100,000 and an IRA worth \$50,000. The payout of the \$50,000 IRA could be substantially tax-free because of the NOL. The client could consider converting the IRA before death to a ROTH IRA to provide future tax-free income benefits for heirs. If a married client's spouse had a significant retirement plan or IRA, the spouse could withdraw funds before the end of the year of the decedent's death to offset the expiring NOL.

- When a client becomes critically ill, an evaluation should be made of the existing actions of the client to make sure opportunities are not lost. For example, assume a client entered into a section 1031 deferred like kind exchange or had an 1033 involuntary conversion before death, but had not closed on the replacement property. Closing on the replacement property before death would assure a step-up in basis for the replacement property.
- Assume a terminally ill client with a non-taxable estate has a will that makes significant charitable bequests. Making the charitable bequests after the death of the client does not provide any estate or income tax savings. However, if the charitable transfers were made before death, the income tax charitable deduction could reduce the client's personal income taxes. Make sure the will is rewritten to remove the charitable bequests.

Post-Mortem Tax Planning for the Estate Much of the focus on post-mortem tax planning has been on the methods of savings estate taxes after death. Instead, post-mortem tax planning may shift to reducing the income taxes of the estate and heirs. For example:

- While a trust is generally required to use a calendar year,<sup>25</sup> an estate can elect any

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<sup>24</sup> Rev. Rul. 74-175, 1974-1 CB 52.

<sup>25</sup> IRC section 645(a).

calendar or fiscal year of not more than 12 months.<sup>26</sup> By selectively choosing a fiscal year, the planner can effectively lower the overall income taxes of heirs and the estate. For example, assume a client dies in October and the estate has significant income before the calendar year end. The personal representative could elect to use a January 31<sup>st</sup> year end for the estate. With proper planning for the underpayment penalty, the taxes on the income that is distributed to beneficiaries would not be taxable until the April 15<sup>th</sup> of the next year.

- If an estate anticipated having significant income tax deductions early in the first year, the estate might consider using a longer fiscal year to allow estate income to offset the early deductions.
- The trustee of “qualified revocable trust” and an executor have the right to elect to treat the trust as a part of the estate.<sup>27</sup> This election can provide living trusts the unique tax benefits of estates, such as the use of a fiscal year, the limited right of an estate to own S corporation stock, and the two year waiver of the passive loss rules.
- Similar planning decisions surround when the estate is closed. This decision should be evaluated based upon income tax impact to beneficiaries. For example, assume most of the estate administration has been completed in November, but the tax year of the estate ends in February. If the estate administration is not completed until the following January, the DNI of the estate from March through January will not be reported on an heir’s tax return until the April 15<sup>th</sup> in the year after the estate was closed. If the estate were closed in November, two years of the estate’s DNI would have been reported in an heir’s tax return (i.e., for the tax year ending in February and the closing of the estate in November).
- Not only is it important to consider the tax years of the estate, it is also critical to consider the tax brackets of heirs when making estate or trust distributions. For example, assume in the previous example that an heir was closing the sale of his business in January. The increased taxable income from the sale of the business might make it more advantageous to close the estate in November.
- Because of broad variances in state income taxes, planners should also consider the relative state income tax brackets of the grantor, the estate or trust and beneficiaries. For example, assume an estate is opened in a state with a fiduciary income tax, but the beneficiaries are all Florida residences. By making income distributions from the estate each year, the potential state income tax could be eliminated.
- The timing of deductible expenses is also a critical income tax planning issue. Most estate administration deductible expenses are not considered business

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<sup>26</sup> IRC sections 441-443 and 645(a).

<sup>27</sup> IRC section 645. Pamela A. Dennett and Mary Lee Moseley, “Maximizing the Benefits of the Section 645 Election,” Estate Planning Journal, November 2004.

expenses. Therefore, they cannot generate a net operating loss for the estate. Therefore, to the extent such deductions exceed income, they are not carried over to future years. However, the code provides that to the extent estate deductions exceed the estate's income in the final year of the estate, the excess deductions can be carried over to the estate beneficiaries.<sup>28</sup> Therefore, personal representatives of cash basis estates with high deductions should consider delaying non-business deductions until the final year of the estate, so heirs can receive the benefit of the deduction. Personal representatives should also be careful about paying too many non-business expenses in any year in which the estate has insufficient income to offset the deduction of the expenses.

- Depreciable estate assets generally step-up to their fair market value at the time of death. With the estate being a new taxpayer, the estate can elect whatever new depreciation method is deemed appropriate to reduce income taxes. The estate is not bound by the depreciation methods that the decedent used.
- If an estate or trust sells an asset, receives an installment sale note and then distributes the note to a beneficiary, the distribution may trigger the inherent gain in the note, resulting in income taxation to the distributing trust or estate.<sup>29</sup> If a distribution to heirs is expected to be proximate in time to the sale and the sale creates a significant recognized gain, it would be far better to distribute the asset and have the beneficiary make the sale, deferring the inherent gain over the term of the note.
- Traditionally, the use of disclaimers in post mortem planning has primarily focused on using disclaimers to minimize estate taxes. With federal estate taxes being less of an issue, tax planning will refocus on using disclaimers to minimize income taxes.

***Planning Example:*** A grandparent dies with a IRA worth \$100,000. The sole heir has four children in college. Each child is in a 10% income tax bracket, while the parent is in a 40% income tax bracket. If the parent took the IRA funds and used them for the college costs of children, the parent would pay \$40,000 in income taxes. If the parent disclaims the IRA and it passes to the college-attending children, the tax is only \$10,000, saving \$30,000 to cover the cost of college.

Planning for the Decedent's Final Income Tax Return. Income tax planning also encompasses planning for the reduction of income taxes based upon the decedent's final income tax return.<sup>30</sup> While the final return is generally due on the April 15<sup>th</sup> after the year of death, if a reasonable cause exists, the personal representative can request up to a six month extension for the filing of the final return.<sup>31</sup>

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<sup>28</sup> IRC section 642(h).

<sup>29</sup> IRC section 453B. If the installment note was obtained by the holder before death and transferred as a result of the death of the holder, a non-sale transfer is not a taxable disposition. See IRC section 453B(c). However, if the note is returned to the obligor of the note, the estate is taxable on the remaining gain. See IRC section 691(a)(5).

<sup>30</sup> For a thorough examination of this topic see, Kasner, Post Mortem Tax Planning, "Elections that Affect Income and Deductions in the Decedent's Final Income Tax Return," section 2.02. (WG&L).

<sup>31</sup> IRC section 6081.

This planning should focus on the relative tax brackets of the decedent, the estate, any trusts and the heirs. By judiciously making elections and allocating income and deductions, the overall tax cost of the heirs can be reduced. However, when the family members have differing goals and tax rates, this planning may create new sources of estate conflict. Among the tax planning possibilities:

- Electing to accrue the interest on Series E or EE US Savings Bonds on the final return.<sup>32</sup>
- The final medical expenses of the decedent can be deducted on the decedent's final return.<sup>33</sup>
- Income from partnerships, LLCs and trusts from the year of the decedent's death must be allocated to the decedent's final return. Therefore, decisions on the timing income and deductions and the allocation of income to the decedent may be a part of the income tax planning for the decedent's estate and heirs.
- In certain circumstances, the final return can be filed as a joint return with a surviving spouse.<sup>34</sup> The joint return will include the decedent's income and deductions for tax year to the time of death and the surviving spouse's income for the entire year. Filing a joint return can offer a number of income tax benefits, including reducing the overall taxes of the married couple, using the expiring losses of a deceased spouse by having the surviving spouse accelerate income (see the above discussion) and having the decedent's post-death income be included in the final return by having the income distributed to the surviving spouse.

### **The Increased Importance of Basis**

While basis issues have always been an aspect of global planning, the income tax benefit derived from basis planning were often eclipsed by the need to minimize a confiscatory federal transfer tax. With the transfer tax less of an issue for most Americans, the income tax planning benefits of planning for the basis of assets is receiving new attention.

Lifetime Basis Issues. Many advisors are unaware of the unique basis issues that apply to gifts. In general, the donee of a gifted asset takes over the tax basis of the donor. IRC section 1015(a) provides: *If the property was acquired by gift ..., the basis shall be the same as it would be in the hands of the donor ... except that if such basis ... is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.*<sup>@</sup> The result of this rule is that the donor's appreciation on the gifted asset will normally be taxed to the donee.

When federal estate tax avoidance was the paramount tax concern, it generally did not make sense to make annual exclusion gifts of low basis assets, because the estate tax avoidance value of the annual exclusion was reduced by the income tax liability which was shifted to the donee. For example, assume a donor intended to gift a zero basis asset

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<sup>32</sup> IRS section 454(a) permits the accrue of the interest on certain non-interest bearing bonds, but is not limited to US Savings Bonds.

<sup>33</sup> IRC section 213(d).

<sup>34</sup> IRC section 6013(a)(2).

using an \$11,000 annual exclusion. If the donee took the donor's carry over basis, the value of the gift (at an assumed capital gain rate of 20%) was effectively diminished by the \$2200 in income taxes. To reduce estate taxes, it was far better to have the donor sell the asset, pay the capital gain taxes and gift \$11,000 in cash. However, if the donor does not have a taxable estate, the gifting of low basis assets may provide an overall tax savings for the donor and donee.

**Planning Example:** Assume a married client has three children in college. The client owns a stock worth \$61,000, with a basis of \$1,000. The client is in an effective state and federal capital gains bracket of 20%, while the children are in a 5% bracket. If the client sells the stock, the net-after-tax proceeds are \$49,000. If the children sell the stock, the after-tax proceeds could be \$58,000.

The benefit of allocating income to lower income taxpayers may be magnified by the recipient's ability to offset the new income by his or her own tax deductions and personal exemptions. Moreover, the transfer of capital assets may become even more pronounced when the capital gain rate potentially reaches 0% in 2008.<sup>35</sup> Using the facts in the above example, the tax savings would be \$12,000.

If the donor's basis in the asset exceeds its fair market value, the rules get a little more complicated for the donee. If the donee subsequently sells the asset for a gain, the donee uses the donor's basis in the property.<sup>36</sup> If the donee sells the asset for a loss, the fair market value of the donated assets is used as the basis. Thus, if the donee sells for a price between the fair market value and the donor's basis, neither a loss or a gain is incurred.<sup>37</sup> Unlike a gift, the basis of an asset transferred at death is the asset's fair market value, even if the fair market value is lower than the assets date of death basis.

**Planning Example:** A terminally ill married client has a currently unmarketable asset which has substantially reduced in value (e.g., the basis is \$500,000 and the value is \$200,000). If the client dies, the asset's basis will step-down to its fair market value, resulting in the family losing the tax benefit of the inherent loss in the asset. Instead, have the terminally ill client gift the asset to his spouse. If the spouse subsequently sells the asset for a value from \$200,000 to \$500,000, no taxable gain will be reported on the sale.

**Planning Example:** The client has a marketable stock she purchased for \$14,000 that now has a value of only \$10,000. If the stock is gifted to a child and the child sells it for \$10,000, the \$4,000 capital loss is effectively lost. Instead, have the client sell the asset for \$10,000 and take a \$4,000 capital loss. The \$10,000 in cash proceeds could then be gifted to the child.

Step-Up in Basis at Death. To the extent assets are includible in a taxable estate, the assets generally obtain a step-up in basis to the assets fair market value.<sup>38</sup> For years,

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<sup>35</sup> This assumes the applicable tax laws are not modified before 2008.

<sup>36</sup> Treasury Regulation. section 1.1015-1(a)(1).

<sup>37</sup> Treasury Regulation section 1.1015-1(a)(2)

<sup>38</sup> IRC section 1014(a).

much of the conflict between tax practitioners and the IRS has been over the undervaluation of assets on federal transfer tax returns. That world is getting ready to change.

With the significant reductions in the number of taxable estates, the IRS and tax practitioners may be ready to change roles. When there is no federal estate tax due, practitioners will want to value assets at higher values to obtain a greater step-up in basis, while the IRS may begin to challenge the higher values and the resulting adverse income tax results of the new federal estate tax exemptions.

***Planning Example:*** In 2006 a terminally ill client owns 40% of a business worth \$4.0 million. The estimated valuation adjustments are 30%. The client's sole heir owns the remaining 60% of the business. The client's remaining assets are \$200,000. If the decedent dies without any changes, the step-up in the 40% business interest would be \$1,120,000. Assume instead, the client purchases a 15% minority interest from the heir for a note for \$420,000. At the client's death, his 55% interest is worth at least \$2.2 million. The note and remaining assets would produce a non-taxable estate of \$1,980,000, while providing a step up in basis for the 55% interest to \$2.2 million. Assuming the heir sold the business after the client's death, the new step-up in basis would save approximately \$216,000 in capital gain taxes, assuming a 20% applicable rate.

While planning for years has attempted to reduce the value of assets, creative planners will begin to look for methods that increase the value of assets, creating a higher step-up in basis for their clients.

While most assets step up to their fair market value at the time of the death of the decedent, if the asset was acquired by the decedent within one year of death and is bequeathed to the donor or a spouse, the deceased's basis in the asset is not stepped-up to its fair market value. Instead, the beneficiary takes the decedent's basis.<sup>39</sup> The purpose of this rule is to assure that taxpayers do not transfer assets to terminally ill family members to obtain a step-up in basis on those assets.

***Planning Example:*** A client's wife is terminal, but owns no assets. In 2005, the donor could transfer up to \$1,500,000 in low basis assets to the spouse, who revises her will to provide that those specific assets pass into a unified credit trust. If the wife dies within one year, the donor/spouse can disclaim his interest in the trust and the assets will step-up to their fair market value, saving taxes for the children. If the wife survives the transfer by one year, the step-up occurs and the disclaimer is unnecessary (i.e., the spouse can remain a beneficiary of the trust). In either case, the family saves up to \$225,000 in federal capital gains taxes.<sup>40</sup>

Choice of Entity. Clients who are considering the type of business entity to use should consider the effect of the death of the business owner on the basis of the business

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<sup>39</sup> IRC section 1014(e)

<sup>40</sup> i.e., \$1,500,000 times a 15% federal capital gains tax

assets. For example, assume the client wants to create a flow-through business entity. Entity choices include partnerships, LLCs and S corporations. However, upon the death of the business owner, LLCs (which are taxed as partnerships) and partnerships permit a step-up in basis in the value of the assets inside the business entity.<sup>41</sup> There is no similar provision for an S corporation.

***Planning Example:*** Assume a decedent owned 99% of a general partnership that held an asset worth \$500,000, which had a basis of \$1,000. Assuming there are no discounts on the value of the partnership, the basis in the partnership asset could increase by \$495,000, eliminating significant income or capital gain taxes on the sale of the asset. If the same asset were held in an S corporation, the corporation's basis in the asset would remain \$1,000.

Redemption Agreements vs. Cross Purchases. There is a basis reason that corporate cross-purchase agreements are better than redemption agreements. If a corporation owns the insurance policy and a shareholder dies, the corporate redemption does not provide any income tax basis adjustment to the surviving shareholders. If the surviving shareholders own the policy on the deceased owner, they receive an increase in their income tax basis in the acquired shares. This limitation does not generally apply to LLCs and partnerships.

***Planning Example:*** Assume three equal shareholders intend to insure each of their lives for \$5,000,000 to fund a buy-sell agreement. Shareholder A dies. If the corporation owns the insurance and carries out the redemption, the remaining shareholders receive no step-up in the tax basis in their stock. However, if the remaining shareholders owned the insurance and used it to acquire the deceased shareholder's shares, each shareholder would each receive a \$2,500,000 increase in the income tax basis in the acquired stock, even though they own exactly the same percentage of stock as they would have owned if the corporation had redeemed the stock. Assuming an effective state and federal capital gain tax rate of 20%, each shareholder could save up to \$500,000 in capital gains taxes when they sold the stock.

### **The Impact on the Use of Trusts**

This new tax environment is also changing how clients and planners approach the use and creation of trusts. Trusts remain one of the most adaptable planning tools available. As a result clients will continue to use trusts to accomplish both tax and non-tax estate planning goals. Income tax planning opportunities using trusts will increasingly become a part of the estate planning process. Among the expectations:

"Spray Trusts". As discussed earlier in the article the new tax environment will encourage the allocation of income to lower bracket taxpayers. The use of Spray@ power to allocate income among various family members (particularly those in lower tax

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<sup>41</sup> IRC section 754. Daniel H. Markstein, "Postmortem Estate Planning with Limited Partnerships," Estate Planning Journal February 2004.

brackets) will be an increasing part of our planning process. Thus, a college student who is in a 10% income tax bracket may be sprayed income out of a trust, resulting in more after-tax dollars to fund the child's college education.<sup>42</sup>

Forum Shopping. The income taxation of grantors, trusts and beneficiaries vary widely from state to state. Even though the tax rate in most states is relatively low, the long term imposition of a state income tax can cost significant tax dollars, especially in states which do not provide any capital gains break. Moreover, the income tax rates on estates and trusts range from zero (e.g., Alaska, Florida) to over nine percent (e.g., California, Vermont).<sup>43</sup> Local income taxes could drive the rates even higher.<sup>44</sup> As a result, clients who are creating trusts (especially trusts that are intended to accumulate dollars) should consider having the trusts created in a forum which minimizes local income taxes.

***Planning Example:*** Assume a client intends to create a trust, contributing an asset worth \$500,000 and having a zero basis. The trust will sell the asset for a installment sale note payable annually over ten years at an 8% interest rate. The trust is intended to provide for the college education of grandchildren who will not begin college for 11 years. Assume the grantor's domicile state will impose an 8% tax on the income and capital gain retained in the trust. The grantor is considering using a Delaware trust that does not impose taxes on trusts that accumulate income for non-resident beneficiaries. If the trust is retained in the donor's state, the state income taxes over the next ten years will be almost \$60,000. If the trust was formed in a non-taxable state, such as Alaska, Delaware or Florida, there might be no income tax liability.

Fiduciary Income Tax Issues. Advisors have not paid nearly as much attention to the rules governing the income taxation of estates, trusts and beneficiaries as the estate tax rules. This will change as income tax planning becomes a higher priority for the majority of estates and trusts.

Advisors will also need to examine estate and trust investment based upon their relative after-tax returns. <sup>45</sup>

***Planning Example:*** Assume a trustee intends to accumulate trust income for ten years until grandchildren of the grantor reach college age. The trustee has two investment choices: an ordinary income investment that generates an 8% return and a capital gain investment that generates a 6.5% annual return. The trust is in an ordinary income tax bracket of 35%, while the capital gain rate is 15%. Ignoring any other investment or tax issues (e.g., trust deductions, investment

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42 Solomon Kamm, Discretionary Trust Distributions – a People Oriented Approach; How to Help our Clients Make Informed Decisions, ABA Section of Real Property, Probate and Trust Law, 10<sup>th</sup> Annual Estate Planning Symposium, May 1999, volume 3.

43 Jeffrey A. Schoenblum, 2004 Multistate Guide to Estate Planning, Table 12 (CCH 2004).

44 e.g., New York City imposes an income tax at a rate of 3.2%. *Id.*

45 William M. VanDenburgh, Philip J. Harmelink, D. Larry Crumbley and Nicholas G. Apostolou, "Investment and Tax Considerations for Capital Preservation," *Journal of Retirement Planning*, November/December 2002;

risk, diversification, etc.) what is the better investment? The net after-tax yield on the ordinary income investment is 5.2%, while the net after-tax yield on the capital gain investment is 5.5%.

Total Return Trusts. Investment models no longer fit into a pure allocation between income and principal. As a result, many clients have adopted spray powers that allow a trustee's discretion to decide how much income should be distributed to beneficiaries. The effective use of a spray trust requires a client to trust the judgment of the appointed trustees. Another alternative is the total return trust.

Because of the perceived need to amend existing trust to provide for total return distributions, states have been adopting statutes that provide for the modification of existing trusts to become total return trusts. Some states have adopted one of the two approaches, while other states have adopted variations of both approaches.

There are two basic approaches to total return trusts. The first approach revises a trust's equitable adjustment power<sup>46</sup> to permit trustees to partially ignore the direct impact of investments on income and remainder beneficiaries. Instead, the trustees are free to invest trust assets based upon obtaining the greatest total return. The trustees have the discretionary right to determine a fair return to income beneficiaries and allocate a portion of principal to income to obtain the desired rate of return. The second approach allows a trustee (sometimes with beneficiary approval) can convert an existing trust to a unitrust, giving income beneficiaries an assured annual rate of return (e.g., a unitrust right to 4.5% of the value of the trust).

Based upon the number of states which have adopted or are considering adopting total return legislation, the use of these types of trust should be expected to grow.<sup>47</sup> The acceleration of states adopting such provisions is at least partially due to an IRS issuance of proposed regulations<sup>48</sup> that provide that such changes may not result in the trust losing the benefit of either the marital deduction or the generation skipping exemption.

Total return trust legislation is primarily directed at correcting unexpected consequences in existing irrevocable documents. However, trust instruments can adopt similar approaches, without having to comply with the restrictions of a state statute. For example, the unitrust rights in most state statutes runs from 3% to 5%. Assume a client creates a trust for a second wife and wants a higher annual distribution. The client might provide that the annual distribution equals all of the income from the trust, but not less than 8% of the value of the trust assets.

Fiduciary Liability Exposure. The failure of a fiduciary and the estate planner to

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<sup>46</sup> Section 104 of the Uniform Principal and Income Act A copy of the Uniform Act can be found at [www.law.upenn.edu/bll/ulc/ulc.htm](http://www.law.upenn.edu/bll/ulc/ulc.htm)

<sup>47</sup> At least 40 states have adopted or are considering adopted of total return trust legislation.

<sup>48</sup> Proposed Regulation section 1.643(b)(1).

properly plan for the estate or trust and a beneficiary's tax liability may open fiduciaries and planners up to new liability claims.<sup>49</sup> Moreover, the conflicting tax rates and goals of beneficiaries may place fiduciaries in the untenable position of managing family conflicts over the tax aspects of the estate or trust's investments and the tax elections.

As a result, part of the planning for estates and trusts will increasingly include ways to minimize the liability of fiduciaries who are acting in good faith.<sup>50</sup> The terms may include revising the standard of fiduciary liability in the applicable instruments, indemnifying fiduciaries and paying any legal fees incurred by fiduciaries.

Estate Defective Trusts. For years, clients and planners have used Income Defective Trusts to reduce a client's federal estate taxes.<sup>51</sup> An Income Defective Trust uses the differences in the income and grantor tax rules<sup>52</sup> to create a trust that remains taxable to the donor for income tax purposes pursuant to IRC Section 671-678, while the trust assets are removed from the grantor's taxable estate.

However, with the recent increases in the unified credit (and the increases still to come), the gap between the income tax and transfer tax rules may create planning opportunities for Estate Defective Trusts. Such trusts are purposely created to have the trust income taxable to the trust or its beneficiaries, but to have the trust assets remain in the grantor's taxable estate.

An Estate Defective Trust ("EDT")<sup>53</sup> has two principal income tax related benefits. First, the tax on the income of an EDT is allocated to either the trust or its beneficiaries. Unlike an Income Defective Trust, the EDT can effectively permit a grantor to use the lower income tax brackets of the trust beneficiaries to reduce the overall taxes of the family.

***Planning Example:*** Assume a client has a grandchild in college, the client owns an asset that generates an annual income stream of \$40,000. The client is in an effective income tax bracket of 40%, while the grandchild is in an effective income tax bracket of 15%. Using an EDT, the family saves \$10,000 in annual income taxes.<sup>54</sup> If the grantor was paying social security or self-employment taxes (e.g., by being the manager of an LLC), the savings would be even more significant.

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49 Mark Merric, Robert D. Gillen and Jane Freeman, "Malpractice Issues and Uniform Probate Code," Estate Planning Journal, December 2004; Thomas W. Abendroth, Scott Bieber and David R. Hodgman, "Managing the Risk of Liability in an Estate Planning Practice," Estate Planning Journal, August 2003

50 Glenn Kurlander, "Enhancing the Protection and Independence of Fiduciaries," Estate Planning Journal, September 2004; Raithele, "Drafting Estate Planning Provisions to Avoid Litigation," Estate Planning Journal, February 2000; G. Michael Richwine, "How Individual Trustees can Avoid Liability and Breaches of Trust," Estate Planning Journal December 1997.

51 George L. Cushing, "Planning with Intentional Grantor Trusts," ALI-ABA Sophisticated Estate Planning Techniques, Boston, September 17, 1992; Randall W. Roth, "The Intentional Use of Tax Defective Trusts," 1992 U. Miami Inst. Est. Plan. section 400; Howard M. Zaritsky, Tax Planning for Family Wealth Transfers, WG&L 1991, section 3.02.; Federal Income Taxation of Estates and Trusts, (WG&L) section 7.03[3]; Irizarry-Diaz, "How Defective is Your Trust? Suggestions on Structuring an Intentionally Defective Grantor Trust," 41 Tax. Mgmt. Memo. No 13, 231 (6/19/2000).

52 John B. Huffaker and Edward Kessell, "How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts," Estate Planning Journal, April 2004;

53 See John J. Scroggin, "The Estate Defective Trust," Taxes, January 2005.

54 i.e., \$40,000 times the 25% difference in tax brackets.

Not only are income tax reduced, but the after tax proceeds from the income are not includable in the grantor=s estate, reducing the possibility that the grantor may be subject to either state or federal transfer taxes.

**Planning Example:** Assume in the above example that the client dies in 20 years, but retained the asset that generated \$40,000 in annual income. Assuming an annual six percent return, the annual after-tax income (even at a 40% income tax rate) from the asset could create an additional estate value of over \$685,000 at the grantor=s death.

Second, many clients hold low basis assets (e.g., a family farm or business). The client may desire to gift the asset to family members, but does not want to lose the benefit of the step up in basis which occurs at death. The client can place the asset in an EDT. Beneficiaries will receive the current benefit of the asset, but the asset will remain part of the grantor=s taxable estate, permitting a step-up in basis.

**Planning Example:** Assume a client owns a business that has a zero basis, but is worth \$500,000. The business is growing at an annual rate of 5%. The client=s son is taking over the business. If the father gifted the asset to his son, the son would take over the father=s zero basis. Assume the father dies in five years, when the business is worth \$640,000. By placing the business in an EDT, if the son sold the business when he was in a 20% effective tax bracket, he would save \$128,000 because of the EDT.

Benjamin Franklin said that only taxes and death are inevitable. As long as we have taxes, tax avoidance will remain a major motivation for many clients. With federal death taxes no longer impacting the vast majority of clients, the avoidance of state and federal income taxes and state inheritance taxes are becoming the prime tax avoidance motive.

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