Deutsche Asset
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Tax Topics

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Planning and STATE estate tax

With the large federal exclusion, many people are no longer subject to federal estate tax – but does that mean they have *no* estate tax concerns? Not if they live in a state with an estate tax or own property there. In that case, *state* estate tax can be a real presence and cost significant dollars. Yet the planning that can help mitigate state (and federal) estate tax also has potential income tax consequences. Here are some considerations to keep in mind:

Planning basics. A $5 million exclusion protects transfers from federal gift and estate tax, and is now "permanent." To the extent an individual doesn't make lifetime gifts that absorb the exclusion, the exclusion will shelter transfers at death. Inflation indexing has increased the exclusion as follows: $5.12 million (2012), $5.25 million (2013) and $5.34 million (2014). Married couples can protect twice these amounts, and when one spouse dies, "portability" ensures that the survivor can effectively "inherit" any of the deceased spouse's unused exclusion, as long as that spouse's executor makes a portability election.

Lifetime gifts. Lifetime gifts can help reduce a donor's potential estate tax by reducing the donor's estate. Donors can make "annual exclusion gifts" and give $14,000 worth of property a year to as many people as they wish ($28,000 if the donor's spouse agrees); they can also make direct payments for tuition, medical expenses and health insurance premiums. Such gifts are "extras" and do not count against the donor's $5.34 million exclusion. Other lifetime gifts typically reduce the exclusion, and generally remove potential appreciation from the donor's estate. Because of the basis rules, however, *any* gift of appreciated property passes along built-in capital gain.

Basis rules. "Basis" typically refers to what someone pays for property. But what is the basis of property when someone dies or makes a lifetime gift? Here are the rules:

- **Individually owned assets.** In general, a decedent's assets – such as stocks, bonds and real estate – are "marked to market" as of date of death; this eliminates built-in capital gains, as well as built-in losses.

No basis step-up is allowed, however, if a decedent receives appreciated property within one year of death and transfers it back to the donor (or the donor's spouse) – so if Mom gives highly appreciated Blackacre to ailing Dad, and Dad transfers it back to Mom when he dies three months later, Blackacre's built-in gain does not disappear.

- **Assets held in trust.** If an individual creates a trust during life or is a trust beneficiary, the trust's assets will be stepped up (or down) at the individual's death IF the individual "owns" the trust for estate tax purposes (meaning that the trust is includible in the individual's estate). This is the case, for example, with a "Revocable Trust," which is fully revocable by the "grantor" who created it, or with marital trusts for the surviving spouse that defer estate tax until the surviving spouse's death (such as a qualified terminable interest property (QTIP) trust).

- **Lifetime gifts.** Cash has no basis. But gifts of appreciated property carry built-in capital gains, since the donee takes the donor's basis (increased by any gift tax paid). Yet gifts of *depreciated* property have a "dual basis": for purposes of determining loss, the donee uses the gift's fair market value at transfer; for purposes of determining (eventual) gain, the donee uses the donor's basis. In other words, for example, if Mom gives Son stock that is worth less than she paid for it, she loses the loss – as does Son. The same "carryover" basis rules apply to lifetime gifts in trust.

State estate tax basics. About 18 states have some kind of "death tax," including New York, New Jersey, Connecticut and Massachusetts, as well as the District of Columbia. State exclusion amounts are not portable (except for Delaware and Hawaii), and can vary greatly, from $675,000 (New Jersey) to matching the federal exclusion (Delaware and Hawaii). In general, however, state exclusion amounts are lower than the federal exclusion, a disparity that can complicate planning, particularly for married couples who create a "credit shelter trust" when the first spouse dies.

- **"Credit shelter trusts."** A credit shelter trust is usually created at the first spouse's death. It typically provides for the surviving spouse and children, and historically has equaled the maximum amount the predeceased spouse can protect from federal estate tax (in other words, the trust is taxable in the predeceased spouse's estate, but is shielded from estate tax by that spouse's exclusion). At the surviving spouse's death, the trust passes tax-free to children (either outright or in further trust) because the surviving spouse is not the estate tax "owner" of the trust; trust assets that have appreciated since the first spouse's death therefore pass estate-tax free to heirs. Full use of the federal exclusion, however, can trigger substantial *state* estate tax. Consider the following examples, which involve New York, and assume Mom and Dad have made no taxable lifetime gifts.

  Example 1 – full use of federal exclusion. Mom and Dad live in New York, where the exclusion amount is currently $2,062,500 (it disappears entirely if a decedent's taxable estate exceeds it by more than 5%). Mom dies in late 2014, with an $8 million estate; Dad and their two children survive her. Mom's will creates a credit shelter trust for Dad and the children; the balance of her estate passes outright to Dad. The trust equals the maximum amount Mom can protect from federal estate tax, or $5.34 million; yet because the trust (Mom's taxable estate) exceeds the New York exclusion by more than 5%, it triggers over $430,000 of New York estate tax.

  Considerations:

  - Full use of the federal exclusion means that more assets (and potential appreciation) are protected from both federal and state estate tax at Dad's death.

- Protecting future appreciation from federal estate tax must be weighed against the “up-front” cost: New York estate tax reduces what Dad currently receives outright; is this “haircut” worth it – especially if widowed Dad moves to a state where there is no estate tax?

- Because the credit shelter trust is not includible in Dad’s estate at his death, there is no basis step-up for trust property that has appreciated since Mom’s death; this could result in significant income tax if heirs liquidate this inheritance.

Example 2 – exclusion capped at New York exclusion. Same facts as above, except that Mom’s credit shelter formula limits the disposition to the “maximum amount that can pass free of federal AND state estate tax.” Because the trust is capped at New York’s $2,062,500 exclusion, Mom’s taxable estate passes free of both federal and New York estate tax; Dad also receives more of Mom’s $8 million estate outright. As Mom’s executor, Dad elects portability for Mom’s $3.27+ million of unused exclusion, which gets added to his own exclusion.

Example 3 – outright disposition to survivor. Mom and Dad have “sweetheart” wills that leave everything to each other (estate tax won’t be payable until they’re both gone). Mom dies on April 1, 2014, and leaves her $4 million estate outright to Dad, who is also her executor. Dad files the necessary New York estate tax return for Mom’s estate; he also files a federal estate tax return to elect portability for Mom’s unused $5.34 million exclusion. Dad dies on December 31, 2014. After expenses, Dad’s total estate is $6 million, or more than his $5.34 million exclusion. Thanks to Mom’s portable exclusion, Dad’s estate is not subject to federal estate tax; it IS, however, subject to New York estate tax of $510,800. If Mom had taken advantage of her $2,062,500 New York exclusion by creating a New York credit shelter trust for Dad in that amount, Dad’s taxable New York estate would have been that much smaller, and would only have incurred $273,900 in New York estate tax – a savings of $236,900.

Planning point: Because the New York exclusion is not portable (like most state exclusions), it is a “use it or lose it” proposition for married couples. If Mom doesn’t use her New York exclusion, and Dad’s estate exceeds *his* New York exclusion by more than 5%, neither estate will have benefited from the exclusion, thereby incurring unnecessary New York estate tax, and reducing their children’s inheritance.

- **New York NON-resident with New York real property.** Suppose that Mom and Dad live in Florida, which has NO state estate tax. Mom’s estate totals $8 million, including her ½ interest in the $800,000 condominium she and Dad jointly own in the Hamptons on Long Island. Mom dies in 2014. Her will creates a credit shelter trust for Dad that takes full advantage of the $5.34 million federal exclusion. The condo passes automatically to Dad by right of survivorship. To Dad’s surprise, Mom’s $400,000 interest in the condo is subject to New York estate tax, even though it is under New York’s $2,062,500 estate tax exclusion. That is because New York taxes real or tangible property that is located in New York; its estate tax calculation treats Mom as if she were a New Yorker. Mom’s taxable estate (the $5.34 million credit shelter trust for Dad) exceeds the New York exclusion by more than 5%, and therefore triggers hypothetical New York estate tax of $431,600. Since Mom’s interest in the condo represents 5% of her estate, her New York estate tax is $21,580 (5% of $431,600).

  Planning point: People who reside in a state *without* an estate tax but who own real or tangible property in a state *with* an estate tax can still face STATE estate tax in that other state. To potentially address this issue, it is worth considering transferring such property to a multi-member limited liability company (LLC) or family limited partnership (FLP), in the hope that the property will be treated as intangible and therefore no longer subject to state estate tax.

Where this brings us:

- Many people who are no longer subject to federal estate tax may still be subject to state estate tax.

- Sheltering future appreciation from estate tax in the surviving spouse's estate typically entails the loss of the basis step-up – this can be costly for heirs if they intend to liquidate their inheritance; the carryover basis rules create a similar problem for lifetime gifts of appreciated property.

- If a married couple is likely to be affected by *state* estate tax, it is worth taking advantage of the state exclusion at the first spouse's death.

Here are some suggested rules of thumb for applying these points:

- **No federal OR state estate tax issues:** make sure planning documents are in place and are current. If lifetime gifts of appreciated property are made, use high basis property.

  Planning point: Regardless of how large someone's estate is, planning documents need to be in place that properly dispose of assets at death, and provide adequate protections for, say, minor children and wayward heirs, perhaps through trusts. In addition, beneficiary designations for assets such as IRAs should be current and still name the right people – if the IRA owner is now divorced and neglects to change the designation to his new spouse, the likelihood is that the (now) ex-spouse will take.

  Planning point: There are many ***non-tax reasons for creating trusts***, including creditor and predator protection, as well as controlling the ultimate disposition of assets while still providing for a beneficiary over the beneficiary's lifetime (this is particularly true in the case of "blended" families, where Mom, for example, wants to provide for Second Husband (H2), but still ensure that the children from her prior marriage will inherit the trust property when H2 dies).

- **STATE estate tax issues only:** married couples should at least take advantage of the STATE estate tax exclusion through use of a state credit shelter trust: most state exclusions are not portable, and it is a "use it or lose it" proposition.

- **State AND federal estate tax issues:** married couples should again take advantage of the state exclusion, and either make an outright disposition of the remaining property to the surviving spouse or consider use of a QTIP trust for the balance: as mentioned above, the QTIP trust will defer estate tax until the surviving spouse's death, and its inclusion in the surviving spouse's estate will mean that appreciated trust property benefits from a basis step-up at that spouse's death.

- **Federal estate tax issues alone:** much will depend on the individual's appetite for complexity and current willingness to part with assets (something that can be a tough sell if the individual is concerned about outliving her assets).

To sum up. While the large federal exclusion may mean that many people no longer have federal estate tax issues, they may still have state estate tax issues. The challenge is balancing the desire to mitigate estate taxes with maximizing a basis step-up for appreciated property at an individual's death. Put differently, planning has gotten harder, not easier!

October 7520 rate

The October 7520 rate remains at 2.2%, where it was in September. The October mid-term rates are: 1.85% (annual), 1.84% (semiannual and quarterly), and 1.83% (monthly). The September mid-term rates were: 1.86% (annual), 1.85% (semiannual and quarterly), and 1.84% (monthly).

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