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Trusts & Estates 2015 Tax Update

Recent years have seen significant shifts in estate, gift, and income tax policies at the federal level. However, after several years of flux, the federal tax landscape has stabilized somewhat. The following summarizes federal and state law that may affect your estate planning and discusses strategies for tailoring your estate plan to maximize tax savings.

Federal Estate and Gift Tax. The current federal estate, gift, and generation skipping transfer (GST) exemption amounts are no longer subject to sunset provisions and will be adjusted each year for inflation. For 2015, the federal exemption amount is $5.43 million. Additionally, portability, which allows a surviving spouse to utilize the unused federal estate and gift tax exemption of his or her last deceased spouse, has been made permanent.

State-Level Estate Tax. On the state level, we have not seen significant shifts to estate tax laws, although Rhode Island raised its estate tax exemption amount to $1.5 million beginning on January 1, 2015. The Rhode Island exemption amount will be annually adjusted for inflation.

State	Estate Tax Exemption Amount	Top Estate Tax Rate
Connecticut	$2 million	12%
Florida	No Estate Tax	—
Massachusetts	$1 million	16%
New Hampshire	No Estate Tax	—
Rhode Island	$1.5 million	16%

Estate Planning in the Current Tax Environment. For many years, when the federal estate tax exemption was significantly lower than it is today and federal estate tax rates were higher, a core objective of estate planning was to shift wealth out of an individual's estate so as to avoid or reduce onerous estate taxes. Many families implemented strategies through which assets were passed from members of the older generation to children or grandchildren in a manner that would avoid estate tax.

The tradeoff with these transfers was the loss of the step-up in basis (for income tax purposes) to fair market value, which is permitted for assets that are included in a deceased person's estate. In the past, when capital gains rates were low and many more estates were subject to a high federal estate tax, it made sense to implement estate planning strategies aimed at reducing the estate tax. However, now that the federal estate tax exemption amount is much higher and capital gains tax rates have increased, these strategies might no longer be appropriate.

Example 1: Taxable Lifetime Gift. Arthur purchased a lake house in New Hampshire 30 years ago. His basis in the house was and remains $50,000. However, the house's value in 2014 was $500,000. In 2014, Arthur transferred the house to his daughter, Barbara. Arthur filed a gift tax return reporting the gift and was not required to pay gift tax because he had unused gift tax exemption. Because the house was transferred by lifetime gift, Barbara took Arthur's basis ($50,000). If Arthur were to die in 2015 with $3 million in assets, no federal estate tax would be due because Arthur's estate would be below the exemption amount, after accounting for his lifetime gift. If Barbara were to sell the house in 2020 for $600,000, she would realize a capital gain of $550,000.

Example 2: Bequest at Death. Varying from Example 1, the lake house, instead of being transferred to Arthur's daughter during Arthur's lifetime, is owned by Arthur upon his death in 2015 and is transferred to Barbara under Arthur's will. Because it would be included in Arthur's estate for federal estate tax purposes, its basis would be stepped-up to the fair market value at the time of Arthur's death. Even with the house, Arthur's estate would still be well below the $5.43 million exemption, so there would still be no federal estate tax due. Barbara's basis in the house would be $500,000 (the fair market value at Arthur's death). If Barbara were to sell the house in 2020 for $600,000, she would realize only $100,000 in capital gain.

Additionally, now that portability has been made permanent, additional estate planning strategies may be employed to maximize overall tax savings.

Example 3: Utilizing Portability. Varying again from Example 1, Arthur's wife, Colleen, has approximately $2 million in assets in her own name. Under Arthur's estate plan, all of his assets, including the lake house, pass to a trust that will be held for the benefit of Colleen during her lifetime, and will then pass to Barbara. The terms of the trust are such that all of the assets in the trust could be includable in Colleen's estate when she dies. The executor of Arthur's estate makes the appropriate elections, including a portability election, on the federal estate tax return for his estate. Colleen dies in 2019 when her personal assets are worth $2.5 million, the lake house is worth $600,000, and the other assets in Arthur's trust are worth $3.5 million. Because Colleen's estate will be able to use her exemption amount, plus Arthur's unused exemption, there will be no federal estate tax due upon Colleen's death. Additionally, Barbara's basis in the lake house will equal the fair market value upon Colleen's death. Assuming, as above, that Barbara were to sell the house in 2020 for $600,000, she would not realize any capital gain.

Summary of Federal Tax Impact

SCENARIO	ESTATE TAX	BARBARA'S INCOME TAX*
Example 1	$0	$130,900
Example 2	$0	$23,800
Example 3	$0	$0

* Assumes that Barbara is taxed at the highest marginal rate for long-term capital gains.

As the foregoing examples illustrate, in addition to planning to minimize estate tax, one should also consider likely income tax consequences for beneficiaries when constructing an estate plan and making gifts. Given the recent changes to federal tax policy, many estate plans that were devised many years ago might no longer be optimal. In addition to federal estate and income tax considerations, there may be state-level estate and income taxes and other factors (such as family dynamics and creditor concerns) that should be considered before implementing any new strategies. An experienced estate planner can help you determine whether the plan you have in place still makes sense for you and your beneficiaries.

An estate plan should be reviewed periodically, not only because one's circumstances might change, but because the laws that appear "permanent" today might change tomorrow.

Federal Income Tax. The 2014 tax year marks the second year to which new income tax rules apply. Most taxpayers' 2014 federal income tax returns will not change significantly from their 2013 returns (assuming that the inputs in 2014 are substantially similar to those in 2013). In the final days of 2014, Congress passed the 2014 Tax Increase Prevention Act, which extended through December 31, 2014 certain taxpayer-friendly provisions, such as the option to take state and local sales tax as an itemized deduction in lieu of a deduction for state and local income tax, and a provision permitting tax-free distributions to charity from an IRA by taxpayers age 70 ½ and older.

Important Federal Tax Numbers for 2015	
Estate, Gift, and GST Tax Exemption	$5.43 million
Top Marginal Estate and Gift Tax Rate	40%
Annual Exclusion Gift Amount	$14,000
IRA Contribution Limit	$5,500 ($6,500 if 50 or older)
Employer 401(k), 403(b), and 457 Plan Contribution Limit	$18,000 ($24,000 if 50 or older)
SEP IRA and Solo 401(k) Contribution Limit	$53,000
SIMPLE IRA Contribution Limit	$12,500 ($15,500 if 50 or older)

Affordable Care Act and 2014 Tax Returns. The IRS has provided guidance on how Affordable Care Act requirements will affect upcoming income tax filings. Individuals and families who obtain their health insurance through a healthcare exchange may be eligible for the premium tax credit. If you purchased your health insurance through an exchange, you will receive a Form 1095-A (Health Insurance Marketplace Statement), which will supply information about your coverage and any premium assistance received. To claim the premium tax credit, you must attach Form 8962 (Premium Tax Credit) to your federal income tax return. Individuals who did not have coverage during 2014 must either have an exemption or make an individual shared responsibility payment. Many people already have qualifying health care coverage and will need only to check a box on their 2014 returns so indicating.

Achieving a Better Life Experience (ABLE) Act. The recently enacted ABLE Act provides a new, tax-advantaged way for families of individuals with disabilities to save for disability-related expenses. The new law allows for the creation of tax-free ABLE accounts, similar to Section 529 education savings accounts. Funds in an ABLE account grow tax free and may be withdrawn tax free if used for qualified, disability-related expenses. Each disabled person is limited to one ABLE account, and total annual contributions may not exceed $14,000. Additionally, the first $100,000 in ABLE account balances will not be counted toward the SSI program's individual resource limit. For more details on this new program, or if you would like assistance in determining whether an ABLE account may be appropriate for a disabled family member, please contact us.

If you have any questions, please contact your Trusts & Estates Group attorney:

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