HINCKLEY ALLEN

# Trust & Estates 2016 Update

Recent years have seen significant shifts in estate, gift, and income tax policies at the federal level. However, after several years of changes, the federal tax landscape has stabilized somewhat. The following summarizes federal and state law that could 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 2016, the federal exemption amount is $5.45 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 in 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 remains unchanged for 2016.

| State | Estate Tax Exemption Amount | Top Estate Tax Rate |
|---|---|---|
| Connecticut | $2 million | 12% |
| Florida | No Estate Tax | N/A |
| Massachusetts | $1 million | 16% |
| New Hampshire | No Estate Tax | N/A |
| Rhode Island | $1.5 million | 16% |
| New York | $4,187,500* | 16% |

*New York is in the process of increasing its estate tax exemption amount to match the federal estate tax exemption amount.

**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 estate taxes. Many families implemented strategies through which assets were passed from members of the older generation to children or grandchildren without incurring estate tax.

The trade-off with these transfers was the loss of the step-up in basis (for income tax purposes) to fair market value at death, which is permitted for assets that are included in a decedent'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 may no longer be appropriate.

*Example 1: Taxable Lifetime Gift. Arthur, a New Hampshire resident, 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 2015 was $500,000. In 2015, 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 transfer tax exemption. Because the house was transferred by lifetime gift, Barbara took Arthur's basis ($50,000). If Arthur were to die in 2016 with $3 million in assets, no federal estate tax would be due because Arthur's estate would be below the federal exemption amount, even 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 ($600,000 in proceeds less her $50,000 basis).*

*Example 2: Bequest at Death. Changing the facts 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 2016 and is transferred to Barbara under Arthur's will. Because the lake house 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. Including the lake house, Arthur's estate would be well below the $5.45 million federal exemption, so there would 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.*

Now that portability has been made permanent, other estate planning strategies may need to be utilized to maximize overall tax savings, as shown in Example 3.

*Example 3: Utilizing Portability. Again with different facts from Example 1, Arthur's wife, Colleen, has approximately $3 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 permit the executor of Arthur's estate to elect to have all of the assets in the trust included in Colleen's estate when she dies, if desired. Arthur dies with a $3 million estate, including the lake house. The executor of Arthur's estate elects to have the entire trust of $3 million included in Colleen's estate, and also elects portability, thereby allowing Colleen to use Arthur's entire unused exemption of $5.45 million.*

*Colleen dies later in 2016 when her personal assets are worth $3.5 million. The assets in Arthur's trust have increased to $3.5 million. In particular, the value of the lake house has increased to $550,000. All of these assets will be included in Colleen's estate for a total of $7 million. Because Colleen's estate will be able to use her own exemption amount of $5.45 million, plus Arthur's unused exemption of $5.45 million, there will be no estate tax due upon Colleen's death. Additionally, Barbara's basis in the lake house will be the fair market value of $550,000 upon Colleen's death. Assuming that shortly after Colleen's death, Barbara sells the house for $550,000, she would not realize any capital gain.*

| Summary of Federal Tax Impact | | |
|---|---|---|
| SCENARIO | FEDERAL 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.

The foregoing examples illustrate that in addition to planning to minimize estate tax, a person who is constructing an estate plan and making gifts should consider the likely income tax consequences for beneficiaries. Given the recent changes to federal tax policy, many estate plans that were devised years ago may no longer be optimal. In addition to estate and income tax considerations, there may be other factors, such as family dynamics and creditor concerns, that should be considered before implementing any new strategy. 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.** Most taxpayers' 2015 federal income tax returns likely did not change significantly from their 2014 returns (assuming that their numbers in 2015 were substantially similar to those of 2014). In the final days of 2014, the tax provisions (known as the "Extenders") were reinstated for 2014, but they expired again on January 1, 2015. However, on December 18, 2015, President Obama signed into law a measure that extended many of these tax breaks through 2016 or 2019 and made several others permanent.

| Important Federal Tax Numbers for 2016 | |
|---|---|
| FEDERAL TAX PARAMETER | AMOUNT FOR 2016 TAX YEAR |
| Estate, Gift, and GST Tax Exemption | $5.45 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) |

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