CPFA'S Quarterly Letter

Comprehensive Personal Financial Advisors, LLC — First Quarter 2014

The passage of the American Taxpayer Relief Act of 2012 (ATRA) likely carried with it important planning considerations for your estate.

Among other changes, ATRA provided that an individual's lifetime exemption, currently $5,340,000, is portable to his/her surviving spouse upon death. This allows the surviving spouse to utilize any unused portion of the deceased spouse's exemption in calculating gift/estate taxes.

As a result, some common estate plan techniques that were prudent under prior law may now be unnecessary and carry unintended, negative consequences. We are available to help you reevaluate your estate plan to ensure that who gets what, when, and how is in line with your objectives.

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Quarterly Commentary

First Quarter 2014

The State of the Estate Tax

With the passage of the American Taxpayer Relief Act of 2012, which became effective in 2013, we once again have a "permanent" estate and gift tax regime (to the extent that any tax regime could ever be permanent). Even though we have touched on certain passages of the new law in earlier articles, we believe it's a good time to provide a more robust overview of the law and point out a couple of important issues to consider in your estate plan. For most, the new structure simplifies planning. For those with larger estates, the planning has become more complicated. Regardless of tax considerations, proper estate planning comes down to designing, implementing, and maintaining a wealth transfer plan that efficiently governs who gets what, when, and how.

Overview

The Estate and Gift tax applies to the transfer of property via lifetime gifts and at death. Additionally, the estate and gift tax laws are "unified" again, meaning that they integrate to cover lifetime gifts and bequests at death.

Gift tax. On an annual basis, donors may gift up to $14,000 to an unlimited number of donees without incurring tax or using a portion of their lifetime exemption, so long as the gift qualifies as a "gift of a present interest." The annual exclusion amount is adjusted for inflation, but only in increments of $1,000, so the exclusion may not increase each year. If a gift to a particular donee exceeds the annual exclusion, the excess amount uses a portion of the lifetime exemption, and therefore, reduces the tax free amount that may be transferred at death.

Estate tax. The lifetime exemption in 2014 is $5,340,000 per person or $10,680,000 for a married couple (these amounts are adjusted annually for inflation). This combined exemption amount will exclude over 99% of all estates from the estate tax. Amounts in excess of the exemption are taxed at a 40% rate. You may recall that spouses may gift or transfer at death an unlimited amount to one another without incurring tax. Because of this marital exclusion, basic estate planning often means that no tax is payable at the death of the first spouse.

Portability

One of the biggest changes in the new law is the concept of portability. In short, portability allows a surviving spouse to use the deceased spouse's unused lifetime transfer exemption. Under the old law, it was often necessary to create an estate plan that contained a "by-pass" trust to ensure that both spouses fully utilized their lifetime exemption, while not depriving the survivor of access to the funds. Many estate plans today contain "by-pass" trust provisions. Now, with portability, "by-pass" trusts may not only be unnecessary, but they may also create unintended negative consequences.

Let's look at an example of how portability works. Consider a couple in their second marriage in which John has $3M in assets in his name, and his wife, Mary has $10M. John's estate plan leaves all of the assets to his children from his prior marriage and, since $2.34M of his lifetime exemption remains unused when he passes away, he transfers it to Mary. When she later passes away, she can use her current exemption of $5.34M (assuming a passing in 2014) plus her deceased husband's unused exemption of $2.34M for a total exempt amount of $7.68M. Anything above that amount would generally be taxed at a 40% rate.

Portability adds flexibility, but ***it must be irrevocably elected on a timely filed estate tax return, even if a return is not otherwise required to be filed***. A number of additional issues arise as a result of portability. For example, the "deceased spousal unused exclusion amount" or DSUEA is not available if either spouse is a nonresident alien. Also, the DSUEA is not indexed for inflation, so it is set as of the date of death of the deceased spouse. Further, DSUEA applies to the most recently deceased spouse, so (continuing the example above) if a Mary marries George after John's passing, and survives George, then the initial DSUEA is lost, but is replaced by George's DSUEA, if any.

What Sayeth your Estate Plan?

As noted above, many estate plans—prudently drafted under the old regime—contain by-pass trust provisions. The common language would read something like this: "I leave the ***maximum amoun***t ***possible*** to my family trust/exempt trust that will result in the least amount of tax possible for my estate. The excess shall be left to my spouse/marital trust." The reason for this wording is to transfer the maximum amount into the by-pass trust so that none of the first spouse's lifetime exemption is left unused. For estates of less than $5.34M, this wording can result in 100% of the first spouse's property being directed to the by-pass trust, thus complicating the surviving spouse's access to the funds. Further, due to the new income taxes on investment income which apply at much lower thresholds for trusts than for individuals, improperly funding a by-pass trust can have negative ongoing income tax consequences as well. These are some of the unintended consequences we mentioned above.

Beware of Additional Complications

The new estate and gift laws have introduced new issues and complicated others. One size does not fit all. Creating an optimal estate plan requires a comprehensive evaluation of the facts. Coordination with income tax planning is not optional, but now vital.

Despite all its glory, portability of the lifetime exclusion is not always the best solution. In some instances, large estates benefit most by fully funding a by-pass trust.

Another important consideration is the estate tax regime of the state in which you live. Several states still have a lifetime exemption of just $1.0M with rates as high as 16%. Since we have clients in many states, we are not able to address all state issues in this article.

Another complication is the interplay with the Generation Skipping Tax issues for clients seeking to leave assets to grandchildren.

Back to the Big Picture

Who gets what, when and how? In many cases, the tax implications of planning have been greatly simplified, but that does not necessarily eliminate the need to plan! Here are a few questions to consider:

- Does the increase in the exemption cause unintended consequences in your current plan?

- Does your by-pass trust get over-funded resulting in limited access to assets for your surviving spouse?

- Do you unnecessarily lose the ability to "step-up" the cost basis of assets passing into a by-pass trust at the second spouse's death?

- Do you lose flexibility with excess funding of the by-pass trust?

- Does your charitable planning strategy change as a result of these tax law changes?

- What's the impact on current and future generations as a result of increased exemptions and portability?

- Do the new laws affect how you view current gifting?

- Which assets should pass to a by-pass trust versus the surviving spouse?

We've attempted to summarize some of the key issues surrounding estate planning under the new law. What should be evident is that, even though the impact of estate taxes has diminished, the need for qualified professional help in this area has not. As your ***comprehensive advisor***, we are available to help you determine whether changes need to be made to your existing plan and, if so, work with your attorney to make sure the appropriate changes are made.

CPFA's Business Update(s)

Note: Annual ADV Offer to Clients

This quarter existing clients will receive a page stating the material changes to CPFA, LLC's most current Form ADV Part II. This document serves as our "brochure" to our clients and contains information and disclosures as required by law and also describes the products and services we offer, the fees we charge, and many other aspects of our business.

In the past, the SEC only required us to notify clients that the document was available upon request; however, recent regulations now require that all existing clients receive a page stating the material changes. However, you are entitled to receive an entire copy of this Part II Form ADV, which serves as CPFA LLC's SEC disclosure brochure at any time. If you would like a copy, contact John Hamel at jhamel@cpfallc.com or (303) 770-0154 ext. 120