Steve Leimberg's Income Tax Planning Email Newsletter - Archive Message #37

Date: 11-Jan-13
From: Steve Leimberg's Income Tax Planning Newsletter
Subject: **Bruce Steiner: ATRA Increases the Income Tax Cost of Asset Protection**

"The American Taxpayer Relief Act of 2012 ("ATRA") has increased the income tax costs of creating trusts to protect assets from the beneficiaries' creditors, including spouses, and to keep the assets out of the beneficiaries' estates for estate tax purposes.

Trusts continue to protect assets against estate taxes and potential creditors, including spouses. However, ATRA has increased the income tax cost of maintaining trusts. Clients should consider whether the benefits of creating trusts outweigh the costs. Trustees should consider whether the benefits of maintaining trusts outweigh the costs.

Both clients and trustees should keep in mind, however, that leaving assets outright or distributing trust assets is a one-way street. Once assets pass to or are distributed to a beneficiary outright, the beneficiary cannot put them into a trust without incurring transfer tax, either upon the transfer or at a subsequent time."

Since the enactment of the American Taxpayer Relief Act of 2012, **LISI** has provided members with detailed analysis from some of the best and brightest subject matter experts:

- In Estate Planning Newsletter #2044, **Ron Aucutt** provided members with his analysis of the transfer tax provisions contained in the American Taxpayer Relief Act of 2012.
- In Income Tax Planning Newsletter #36, **Michael Jackson** and **Jared Szychter** analyzed the bill's income tax provisions.
- In Estate Planning Newsletter #2045, **David Pratt** and **Scott Bowman** provided members with their analysis of the legislation's transfer tax provisions.
- In Estate Planning Newsletter # 2046, **Marty Shenkman** weighed-in with his analysis.
- In Charitable Planning Newsletter #199, **Richard Fox** provided members with his analysis of the bill's retroactive charitable IRA rollover provision.
- In Charitable Planning Newsletter #200, **Bernie Kent** provided some much-needed clarity regarding the so-called Pease provision and its impact on 2013 charitable contributions.

Now, **Bruce Steiner** reminds members of the fact that ATRA has increased the income tax costs of creating trusts to protect assets from the beneficiaries' creditors. In his commentary, Bruce reviews ways to mitigate the effect of the increase in the tax rates for trusts.

Bruce D. Steiner, of the New York City law firm of **Kleinberg, Kaplan, Wolff & Cohen, P.C.**, and a member of the New York, New Jersey and Florida Bars, is a long time LISI commentator team member and frequent contributor to Estate Planning, Trusts & Estates and other major tax and estate planning publications. He is on the editorial advisory board of Trusts & Estates, and is a popular seminar presenter at continuing education seminars and for Estate Planning Councils throughout the country. He was named a New York Super Lawyer in 2010, 2011 and 2012.

Bruce has been quoted in various publications including *Forbes*, the *New York Times*, the *Wall Street Journal*, the *Daily Tax Report*, *Lawyers Weekly, Bloomberg's Wealth Manager, Financial Planning, Kiplinger's Retirement Report, Medical Economics, Newsday*, the *New York Post*, the *Naples Daily News, Individual Investor*, TheStreet.com, and Dow Jones (formerly CBS) Market Watch.

Before we get to Bruce's commentary, members should note that a new **60 Second Planner** by **Bob Keebler** was recently posted to the **LISI** homepage. The American Taxpayer Relief Act of 2012 imposes new, higher income tax rates on estates and trusts. In his podcast, Bob explains how to avoid the higher rates for a new estate's first fiscal year. You don't need any special equipment - just click on this link.

Members should also note that **Alan Gassman** recently updated some of his charts, and members should use the following link to view those updates: Alan Gassman

Now, here is Bruce Steiner's commentary:

EXECUTIVE SUMMARY:

The American Taxpayer Relief Act of 2012 ("ATRA") has increased the income tax costs of creating trusts to protect assets from the beneficiaries' creditors, including spouses, and to keep the assets out of the beneficiaries' estates for estate tax purposes.

FACTS:

ATRA made most of the temporary income tax cuts enacted in 2001 and 2003 permanent. However, there are several exceptions.

The top income tax rate increases from 35% to 39.6% for taxable income over $400,000 (single) or $450,000 (joint), and $11,950 for estates and trusts. The tax rate on qualified dividends and capital gains increases from 15% to 20% for taxable income over $400,000 (single) or $450,000 joint, and $11,950 for estates and trusts.

In addition, under the Affordable Care and Patient Protection Act, there is a 3.8% Medicare tax on the lesser of net investment income or taxable income above $200,000 (single) or $250,000 (joint), or $11,950 for estates and trusts.

As a result, many estates and trusts will be taxable at 43.4% on ordinary income and 23.8% on qualified dividends and capital gains, while many beneficiaries will be taxable at lower rates. Under ATRA, the estate and gift tax exempt amounts, and the GST exemption, are $5,250,000 (in 2013), indexed for inflation.

COMMENT:

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The Will of a married person typically creates a credit shelter trust for the estate tax exempt amount, to keep that amount, together with the income and growth thereon, out of the surviving spouse's estate, but available for the spouse in case he or she ever needs it. The credit shelter trust also protects against the spouse's potential creditors, including future spouses, as well as Medicaid (within certain limitations).

Some married persons also leave the amount in excess of the estate tax exempt amount in a marital (QTIP) trust for the benefit of the spouse. While the QTIP trust is includible in the surviving spouse's estate (to the extent the deceased spouse's executors claim the marital deduction), it protects the principal against the spouse's potential creditors, including future spouses, as well as Medicaid (within certain limitations).

Similarly, upon the surviving spouse's death, many people provide for their children in trust rather than outright, to keep the children's inheritances out of their estates, and to better protect against the children's potential creditors, including spouses.

There is an income tax tradeoff for these protections. Trusts reach the top bracket at a very low level of taxable income (probably $11,950 in 2013, indexed for inflation). For 2013, the tax rate on taxable income above this level has gone up from 35% to 43.4% on ordinary income and from 15% to 23.8% on qualified dividends and long-term capital gains, in each case including the 3.8% Medicare tax on net investment income. In addition, except for marital trusts and trusts subject to GST transfer tax at a beneficiary's death, there is no basis step-up at death for assets in a trust upon the death of a beneficiary.

At the same time, the tax rates for most beneficiaries have not increased. The 3.8% Medicare tax on net investment income does not affect beneficiaries with income under $200,000 (single) or $250,000 (joint), and the increase in the top bracket from 35% to 39.6% does not affect beneficiaries with taxable income under $400,000 (single) or $450,000 (joint).

As a result of both the increased tax rate on trusts and portability becoming permanent, some married clients may be willing to give up the protection of a credit shelter trust and dispense with the marital and credit shelter trusts and leave their estates to their spouses outright, perhaps with a disclaimer trust as backup. In this regard, a disclaimer trust may provide some degree of asset protection, though a beneficiary's ability to disclaim to avoid existing creditors varies from state to state, and a disclaimer or the failure to claim an elective share may be treated as a transfer for Medicaid purposes.

Similarly, some clients may provide for their children outright rather than in trust, though in the case of a child there may be a greater need for a trust to provide for the management and control of the assets, as well as to protect against potential creditors, including spouses.

It should be noted that portability is not equivalent to a credit shelter trust from a transfer tax standpoint. The deceased spousal unused exclusion amount (DSUEA) is not indexed for inflation, and there is no portability for GST tax purposes. However, for the vast majority of taxpayers, a $5,250,000 (indexed) estate tax exempt amount, together with portability, is sufficient to eliminate any estate tax in the surviving spouse's estate, as well as in the children's estates.

If a trust is created, or if a trust already exists, there are some ways to mitigate the effect of the increase in the tax rates for trusts:

- Invest for qualified dividends, long-term capital gains and tax-exempt income. For some trustees, paying tax at 23.8% on qualified dividends and capital gains is acceptable.
- Limit turnover, so as to minimize capital gains taxes.
- Distribute income to beneficiaries. To the extent the trust distributes income, the income will be included in the beneficiary's estate, and will be subject to the beneficiary's creditors, including spouses. If the beneficiary's estate is too small to pay estate tax, throwing the income into the beneficiary's estate will not result in additional tax. The trustees can evaluate the risk of creditors and spouses on a case by case basis.
- Distribute capital gains to beneficiaries. It is sometimes possible to include capital gains in distributable net income (DNI), in which case the capital gains will pass through to the beneficiaries.

Another solution is for the client to convert to a Roth IRA during lifetime. A client who converts to a Roth IRA will pay the tax on the conversion at his or her own tax rate. The client or his or her surviving spouse can then leave the Roth IRA to the children in trust rather than outright, thereby achieving the benefits of a trust (keeping the inherited IRA out of the child's estate, and better protecting it against the child's potential creditors, including spouses), without subjecting the IRA distributions to tax at the trust's tax rate.

Since the 39.6% bracket does not apply to taxable income under $400,000 (single) or $450,000 (joint), most IRA owners can convert at rates below 39.6%, spreading the conversion over a number of years if appropriate. Moreover, since the 35% bracket only applies to taxable income between $398,350 and $400,000 (single) or between $398,350 and $450,000 (joint), most IRA owners can convert at 28% or lower.

As previously noted, the Roth conversion generally makes sense to the extent the tax rate on the conversion is less than, the same as, or "not too much higher" than the tax rate that would otherwise apply to distributions from the IRA. By limiting the rate increase to upper income taxpayers, the Roth conversion remains attractive for many IRA owners.

Concluding Observation:

Trusts continue to protect assets against estate taxes and potential creditors, including spouses. However, ATRA has increased the income tax cost of maintaining trusts. Clients should consider whether the benefits of creating trusts outweigh the costs. Trustees should consider whether the benefits of maintaining trusts outweigh the costs.

Both clients and trustees should keep in mind, however, that leaving assets outright or distributing trust assets is a one-way street. Once assets pass to or are distributed to a beneficiary outright, the beneficiary cannot put them into a trust without incurring transfer tax, either upon the transfer or at a subsequent time.

IRA owners should consider converting to a Roth IRA.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Bruce Steiner

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CITES:

Section 2654(a); American Taxpayer Relief Act of 2012 (H.R. 8, 112th Cong., 2d Sess.); "American Taxpayer Relief Act of 2012: President Signs Eleventh-Hour Agreement to Avert Fiscal Cliff," CCH Tax Briefing, http://tax.cchgroup.com/downloads/files/pdfs/legislation/ATPR.pdf (Jan. 3, 2013). "CCH Projects Inflation-Adjusted Tax Brackets and Other Amounts for 2013," http://www.cchgroup.com/wordpress/index.php/tax-headlines/federal-tax-headlines/cch-projects-inflation-adjusted-tax-brackets-and-other-amounts-for-2013/ (Sept. 17, 2012); Bruce D. Steiner, "Steiner: Guidance for 2010 Roth Conversions," Employee Benefits and Retirement Planning Newsletter #556 (Dec. 29, 2010); Bruce D. Steiner, Roth Conversions: More and Better," Employee Benefits and Retirement Planning Newsletter #252 (Jul. 8, 2004).

2 Comments Posted re. *Bruce Steiner: ATRA Increases the Income Tax Cost of Asset Protection*

F. Bentley Mooney, Jr. 13-Jan-13 05:20 PM

A different facet to the discussion of ". . . ways to mitigate the effet of the increase in . . . tax rates for trusts" is application of the tactics described to the foreign nongrantor trust. Such trusts usually come about by means of non-U.S. grantor, change from grantor trust to nongrantor on death of the U.S. settlor, and by design as part of a foreign private annuity transaction.

The two material differences in treatment of the foreign and domestic nongrantor trusts are (a) retention of the throwback rules for foreign trusts, and (b) classification of capital gains as "income" under foreign trust accounting rules. As to the former, recognition of a 10-year-old income item, when interest charges are added, imposes a 100% tax on the U.S. beneficiary/distributee. As to the latter, when dealing with the gain on death of the surviving annuitant, the entire trust estate is "income" for the year of death and any retention is "principal" in the following taxable year.

Not a problem if tax-free terminating distributions are made(two or more installments under IRC Section 663), but a big problem if the gain is retained in generation-skipping trusts for children and more remote issue. The answer may be to limit first-year distributions to 4% of "income" (the entire estate under the private annuity), and distribute all current income each year thereafter. Perhaps -- for flexibility -- the drafter might add up to 10% of any accumulation from the prior year's income (limiting the interest charge to one year).

F. Bentley Mooney, Jr. 13-Jan-13 05:20 PM

Well-done.

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