The Shifting Role of Taxes in Estate Planning

I am often asked if Estate Planning has gotten easier as a result of recent changes in federal and Maryland estate tax law. My response: Estate Planning has not gotten easier, it has just become different. Coupled with other changes in society (e.g., lengthening mortality, volatile securities markets, a lengthy period of extremely low interest rates, and new artificial methods of conception), the need for flexibility in Estate Planning seems to have taken on new importance. This article focuses on how the concerns planners address are evolving in light of recent tax law changes.

Generally speaking, if a decedent's assets are subject to potential estate taxation when he or she dies (and even if available exemptions are present to preclude such estate taxation), the capital gains basis of such "property acquired from a decedent" in the hands of his beneficiaries "steps up" (or "steps down") to its fair market value at the date of the decedent's death. Such beneficiaries as a result receive this property without the inherent capital gains income that was realizable before the decedent's death. (Note, however, that this principle does not apply to property that is "income in respect of decedent" such as IRAs and other retirement plans, annuities, Series E savings bonds, or other property where inherent ordinary income has been earned but not yet taxed when a decedent passes away.)

Because the reduction of potential future capital gains taxes by "step up" requires potential exposure to estate taxation at the time of the decedent's death, a fundamental tension has long existed in estate planning (especially for married couples) between saving estate taxes and saving capital gains taxes. Do we maximize the amount we can exempt from estate tax by placing the first decedent spouse's assets after his death in a "credit shelter trust" designed to benefit the surviving spouse without having those assets included in her taxable estate? Or do we expose as much of the couple's net worth as possible to potential estate tax at the death of the survivor to maximize basis "step-up"? A comparable tension exists in Medicaid planning for single individuals where the question becomes: should the potential Medicaid recipient gift his property to family members (who receive the donor's cost basis) to "spend down" assets to qualify rather than leaving these assets to beneficiaries at his death with a stepped-up capital gains basis?

For a long time, resolution of this tension was easy. If likely estate taxation would occur at 55% of date of death value for federal purposes and from 8% to 16% of such value for Maryland estate tax purposes, there was no question that avoiding such estate taxation by preserving all available exemptions far outweighed the potential of future 15% income taxation on capital gains. Such easy resolution has, however, become very much more difficult in the recent past for a number of reasons:

First, recent dramatic increases in estate tax exemptions have significantly decreased the number of estates where estate taxation is potential or likely. Where a decedent could once only shelter $600,000 from potential federal and state estate taxes, decedents dying before 2026 can each now shelter some $11.2 million of their asset value from federal and Maryland estate taxation. After 2025, even if the federal law is not changed, decedents will still be able to shelter some $6 million from estate taxation. For persons likely to die before 2026 with less than $11.2 million or afterward with no more than $6 million, estate planning to minimize future capital gains taxes has become obvious because their families will not have to worry about estate taxation.

Second, since 2010, a predeceasing spouse can avoid wasting his estate tax exemption by means of "Portability" without using a credit shelter trust that precludes a step-up in basis at his surviving spouse's death. Portability allows the executor of a deceased spouse to make an election on the first decedent spouse's estate tax return to transfer or "port" such deceased spouse's unused estate tax exemption to the surviving spouse's estate. For example, if two spouses each have $5 million in assets, prior law would have required the first decedent spouse to use as much of his estate tax exemption as possible for a credit shelter trust to avoid his family's loss of its benefits. In so doing, no further basis step-up would be available for that trust property when the surviving spouse died. Now, however, the first decedent spouse can leave his entire estate to the surviving spouse to be potentially estate taxed when his surviving spouse dies (and with everything other than income in respect of decedent getting a basis step-up at this later date) when the surviving spouse's estate will potentially have available exemptions of over $16.2 million until 2026 (i.e., $5 million "ported" from the first decedent spouse plus the survivor's personal $11.2 million exemption) or some $11 million (i.e., the first decedent's $5 million and the survivor's $6 million) thereafter. For married couples with larger estates, it is now possible to leave up to $22.4 million before estate taxes apply, with all such property potentially receiving a stepped-up basis at the second death. With such large exemptions from estate taxation available at the survivor's death, getting as much capital gains basis step-up as possible at the second death has become the primary priority in many more couples' estate planning. Note, however, that obtaining the advantages of such Portability requires the time and expense of preparing and filing of a federal estate tax return when the first decedent spouse dies; and, unlike credit shelter trust assets, appreciation of "ported" assets do not escape inclusion in the surviving spouse's taxable estate.

Finally, the rates of taxation for these two planning alternatives are narrowing. Federal estate taxation is now at 40%, rather than 55%, of fair market value at death. For those assets to which Maryland estate tax applies, the combined federal and state estate tax rate is just under 50%. At the same time, capital gains income tax rates have climbed over the years. In addition to the original 15% federal rate, an additional 3.8% net investment income tax on capital gains now exists for individuals earning more than $200,000 (or $250,000 for married couples filing jointly) and an additional 5% capital gains tax (above the net investment income tax) applies for individuals earning more than $425,800 annually (or $479,000 for married couples filing jointly). In addition, state income taxes on capital gains apply with most taxpayers paying between 7% and 9% of such gains, depending on income and county of residence. Thus, combined federal and state capital gains rates of tax at over 30% has become closer to combined federal and Maryland estate tax rates at just under 50%. This is not to say that the taxes paid for capital gains will be more than the estate tax due because the tax base for each is very different. However, the increased burden of capital gains taxation has taken on new importance when estate taxes (and especially federal estate tax) are no longer a major consideration because of increased exemptions and Portability.

As I noted at the outset, these tax changes have not made Estate Planning easier, just different. We often now focus more on capital gains tax minimization than we do on estate tax minimization. If, as expected, Maryland this year reverses its 2019 recoupling with the federal estate tax exemption (because it doesn't want the Maryland estate tax exemption to climb to $11.2 million), another level of complexity and an increased need for flexibility will be introduced. As we try to emphasize to all our clients, such law changes and changes in family dynamics make it extremely difficult to plan for more than the next 3 to 5 years. Estate Planning is a process, not a one-time event; and providing flexibility to accommodate change is increasingly critical.