Estate and Income Tax Planning for "Small" Massachusetts Estates

(Now Under $11 Million!)

Paul M. Cathcart, Jr., Hemenway & Barnes LLP

Charles R. Platt, Hemenway & Barnes LLP

Hemenway & Barnes LLP

Outline

1. Highlights from the Current Landscape
2. Strategic Planning for Married Couples
3. Tactical Planning for Income Tax Basis
4. Tactical Planning for the Massachusetts Estate Tax

Highlights from the Current Landscape

I. Temporary Federal Estate and Gift Tax Exemption of approx. $11.2 M
   A. scheduled to increase with inflation
   B. scheduled to be cut in half in 2026
   C. "portable," but DSUE does not increase with inflation
   D. believed to be usable or portable before 2026 without subsequent "clawback"[1]
   E. flat 40% rate above exemption amount

II. Massachusetts Estate Tax
   A. $1 M quasi-exemption;[2] does not increase with inflation
   B. separate QTIP election permitted, DOR Dir. 03-2
   C. no Massachusetts gift tax
   D. limited territorial reach[4]
   E. graduated rate, capped at 16% for taxable estates exceeding approx. $10 M

III. Step-Up in Income-Tax Basis of Assets Included in Federal Gross Estate
   A. eliminates built-in gain otherwise potentially subject to income tax
   B. generally requires inclusion in federal gross estate
   C. Massachusetts basis appears to equal federal basis[4]
   D. typical investment gain is taxed at a 18.8%–23.8% federal rate plus a 5.1% Massachusetts rate

1 *See* I.R.C. § 2001(g)(2) (added by the so-called Tax Cuts & Jobs Act of 2017).
2 Lifetime gifts count against exemption but do not otherwise affect the Massachusetts estate tax due.
3 *Treichler v. Wisconsin*, 338 U.S. 251 (1949); *Frick v. Pennsylvania*, 268 U.S. 473 (1925); *accord Estate of Fasken*, 19 Cal.3d 412 (1977).
4 G.L. c. 62, § 6F(b)(2)(C); DOR Dir. 11-7; 2017 Form 1 Sched D Instructions 28 (citing TIR 88-7). *Contra Treat v. Comm'r of Revenue*, 52 Mass. App. Ct. 208 (2001).

Hemenway & Barnes LLP

Recent Historical Landscape

- Federal Estate Tax
  - lower exemption
  - “use it or lose it”
  - higher rates
- Massachusetts estate tax was roughly the same.
- Income taxes were roughly the same.

Principal objective was to **avoid federal estate tax**.

Current Landscape

- Federal Estate Tax
  - Many comfortable clients expect not to be subject to the tax.
- Massachusetts Estate Tax
  - All of a sudden this number looks bigger.
- Income Tax
  - Expanded opportunity for avoidance, perhaps underappreciated by clients.

Principal focus in this range: **income and Massachusetts estate taxes**.

Strategic Planning for Married Couples

Hemenway & Barnes LLP

Full Credit-Shelter Trust Plan

Assumptions: $10 M Couple; Evenly Divided 6% Net Annual Appreciation = 10% Nominal Appreciation - 4% Consumption and Charges

	First Death (2018)			Second Death (2025)		
Individual Assets	$5.00 M		(Net Appr'n)	$7.50 M	**Fed. Gross Estate: $7.50 M**	**Mass. Gross Estate: $13.50 M**
Mass.-Only QTIP		$4.00 M	Net Appr'n →	$6.00 M		
Exempt		$1.00 M	Net Appr'n →	$1.50 M	Built-In Gain: $2.50 M **Potential Income Tax: $0.60 M[1]**	
Fed. Exemption	$11.20 M		(Infl.-Adj.)	$13.80 M[2]		
<u>DSUE</u>		$6.20 M	Not Infl.-Adj.	<u>$6.20 M</u>		
Total	$11.20 M			$20.00 M	**Fed. Estate Tax: $0 M**	
Mass. Exemption	$1.00 M		Not Infl.-Adj.	$1.00 M	**Mass. Est. Tax: $1.60 M**	

1 Assumes 5.1% Massachusetts income tax and 18.8% federal income tax (including net investment income tax) with no marginal state income tax deduction.
2 Assumes 3% annual inflation rate and 2018 law unchanged.

Full-QTIP Trust Plan

Assumptions: $10 M Couple; Evenly Divided — 6% Net Annual Appreciation = 10% Nominal Appreciation - 4% Consumption and Charges

	First Death (2018)			Second Death (2025)		
Individual Assets	$5.00 M		(Net Appr'n)	$7.50 M	**Fed. Gross Estate: $15.00 M**	**Mass. Gross Estate: $13.50 M**
Full QTIP		$4.00 M	Net Appr'n →	$6.00 M		
Fed.-Only QTIP		$1.00 M	Net Appr'n →	$1.50 M	Built-In Gain: $0.00 M **Potential Income Tax: $0.00 M[1]**	
Fed. Exemption	$11.20 M		(Infl.-Adj.)	$13.80 M[2]		
DSUE		$11.2 M	Not Infl.-Adj.	$11.20 M		
Total	$11.20 M			$25.00 M	**Fed. Estate Tax: $0 M**	
Mass. Exemption	$1.00 M		Not Infl.-Adj.	$1.00 M	**Mass. Est. Tax: $1.60 M**	

1 Assumes 5.1% Massachusetts income tax and 18.8% federal income tax (including net investment income tax) with no marginal state income tax deduction.
2 Assumes 3% annual inflation rate and 2018 law unchanged.

Full Credit-Shelter Trust Plan

- Pros
  - More flexibility re: beneficiaries of credit-shelter trust.
  - Can be made "automatic," or with "Clayton QTIP,"[1] the decision can be deferred until there is more information.
    - QTIP election made on estate tax return.
- Cons
  - Wariness of spouse.
  - Difficult to explain.
  - Funding formula depends on either:
    - federal and state death-tax law, which varies by jurisdiction and over time; or
    - fiduciary "Clayton QTIP" election, which could expose the fiduciary to liability.
  - Additional action necessary to permit basis step-up of credit-sheltered assets upon second death:
    - Formula General Power of Appointment for Surviving Spouse
    - Independent Third-Party Authority to Add General Power of Appointment
    - Surviving Spouse Intentionally Triggers So-Called Del. Tax Trap under I.R.C. § 2041(a)(3)?
    - Modification/Decanting
    - Outright Distributions

1 *Estate of Clayton v. Comm'r*, 976 F.2d 1486 (5th Cir. 1992), the holding of which is now incorporated into Treas. Reg. 20.2056(b)-7(d)(3).

Full-QTIP Trust Plan

Hemenway & Barnes LLP

- Pros
  - Generally defers the decision until there is more information.
    - QTIP election made on estate tax return.
  - Easy to explain.
- Cons
  - Possible loss of DSUE if surviving spouse remarries and survives new spouse.
  - Additional action might be necessary to avoid federal estate tax upon second death.
    - But that's a good problem to have, which may be addressed later using familiar techniques.
  - More difficult to benefit persons other than surviving spouse if the family is not cooperative.
    - Qualified disclaimer into family (credit-shelter) trust.

Full Credit-Shelter vs. Full QTIP Decision: *Income vs. Fed. Estate Tax Considerations*

Hemenway & Barnes LLP

- Current Wealth
- Expected Unrealized Appreciation Rate (Net Consumption/Charges)
- Time Horizon
  - Second Death
  - Income Tax Realization Events (e.g., Proximity of Anticipated Sale)
- Expected Additions to Surviving Spouse's Estate (and Their Tax Characteristics)
- Changes in the Law

Full Credit-Shelter: High-Growth Assets

Hemenway & Barnes LLP

Assumptions: $10 M Couple; Evenly Divided

16% Net Annual Appreciation = 20% Nominal Appreciation - 4% Consumption and Charges

	First Death (2018)			Second Death (2025)	
Individual Assets	$5.00 M		(Net Appr'n)	$14.10 M	**Fed. Gross Estate: $14.10 M**
Mass.-Only QTIP		$4.00 M	Net Appr'n →	$11.30 M	**Mass. Gross Estate: $25.40 M**
Exempt		$1.00 M	Net Appr'n →	$2.80 M	Built-In Gain: $9.10 M **Potential Income Tax: $2.20 M[1]**
Fed. Exemption	$11.20 M		(Infl.-Adj.)	$13.80 M[2]	
DSUE		$6.20 M	Not Infl.-Adj.	$6.20 M	
Total	$11.20 M			$20.00 M	**Fed. Estate Tax: $0 M**
Mass. Exemption	$1.00 M		Not Infl.-Adj.	$1.00 M	**Mass. Est. Tax: $3.50 M**

1 Assumes 5.1% Massachusetts income tax and 18.8% federal income tax (including net investment income tax) with no marginal state income tax deduction.
2 Assumes 3% annual inflation rate and 2018 law unchanged.

Full QTIP: High-Growth Assets

Hemenway & Barnes LLP

Assumptions: $10 M Couple; Evenly Divided

16% Net Annual Appreciation = 20% Nominal Appreciation - 4% Consumption and Charges

	First Death (2018)			Second Death (2025)		
Individual Assets	$5.00 M		(Net Appr'n)	$14.10 M	Fed. Gross Estate: $28.30 M	Mass. Gross Estate: $25.40 M
Full QTIP		$4.00 M	Net Appr'n →	$11.30 M		
Fed.-Only QTIP		$1.00 M	Net Appr'n →	$2.80 M	Built-In Gain: $0.00 M Potential Income Tax: $0.00 M[1]	
Fed. Exemption	$11.20 M		(Infl.-Adj.)	$13.80 M[2]		
DSUE		$11.2 M	Not Infl.-Adj.	$11.20 M		
Total	$11.20 M			$25.00 M	**Fed. Estate Tax: $0 M**	
Mass. Exemption	$1.00 M		Not Infl.-Adj.	$1.00 M	**Mass. Est. Tax: $3.50 M**	

1 Assumes 5.1% Massachusetts income tax and 18.8% federal income tax (including net investment income tax) with no marginal state income tax deduction.
2 Assumes 3% annual inflation rate and 2018 law unchanged.

Full Credit-Shelter: High-Growth/2026 Death

Assumptions: $10 M Couple; Evenly Divided — 16% Net Annual Appreciation = 20% Nominal Appreciation - 4% Consumption and Charges

	First Death (2018)			**Second Death (2026)**		
Individual Assets	$5.00 M		(Net Appr'n)	$16.40 M	**Fed. Gross Estate: $16.40 M**	**Mass. Gross Estate: $29.50 M**
Mass.-Only QTIP		$4.00 M	Net Appr'n →	$13.10 M		
Exempt		$1.00 M	Net Appr'n →	$3.30 M	Built-In Gain: $11.40 M **Potential Income Tax: $2.70 M[1]**	
Fed. Exemption	$11.20 M		(Infl.-Adj.)	$7.10 M[2]		
DSUE		$6.20 M	Not Infl.-Adj.	$6.20 M[3]		
Total	$11.20 M			$13.30 M	**Fed. Estate Tax: $0 M**	
Mass. Exemption	$1.00 M		Not Infl.-Adj.	$1.00 M	**Mass. Est. Tax: $4.20 M**	

1 Assumes 5.1% Massachusetts income tax and 18.8% federal income tax (including net investment income tax) with no marginal state income tax deduction.
2 Assumes 3% annual inflation rate and 2018 law unchanged.
3 *See* Treas. Reg. 20.2010-2(c).

Full QTIP: High-Growth/2026 Death

Hemenway & Barnes LLP

Assumptions: $10 M Couple; Evenly Divided — 16% Net Annual Appreciation = 20% Nominal Appreciation - 4% Consumption and Charges

	First Death (2018)			Second Death (2026)		
Individual Assets	$5.00 M		(Net Appr'n)	$16.40 M	**Fed. Gross Estate: $32.80 M**	**Mass. Gross Estate: $29.50 M**
Full QTIP		$4.00 M	Net Appr'n →	$13.10 M		
Fed.-Only QTIP		$1.00 M	Net Appr'n →	$3.30 M	Built-In Gain: $0.00 M **Potential Income Tax: $0.00 M[1]**	
Fed. Exemption	$11.20 M		(Infl.-Adj.)	$7.10 M[2]		
DSUE		$11.2 M	Not Infl.-Adj.	$11.20 M[3]		
Total	$11.20 M			$18.30 M	**Fed. Estate Tax: $4.10 M**	
Mass. Exemption	$1.00 M		Not Infl.-Adj.	$1.00 M	**Mass. Est. Tax: $4.20 M**	

1 Assumes 5.1% Massachusetts income tax and 18.8% federal income tax (including net investment income tax) with no marginal state income tax deduction.
2 Assumes 3% annual inflation rate and 2018 law unchanged.
3 *See* Treas. Reg. 20.2010-2(c).

Tactical Planning for Income Tax Basis

Hemenway & Barnes LLP

Basic Income-Tax Basis Management[1]

- Get steps up
- Try to avoid steps *down*
- Prioritize if possible:
  - highly-appreciated assets;
  - assets likely to be sold or taxably exchanged before another basis step-up;
  - assets subject to potentially higher income tax rates—e.g., collectibles and self-created copyrights.

1 Paul S. Lee et al., *Putting It On & Taking It Off: Tax Basis Management Today (for Tomorrow)* (Heckerling 2018).

Upstream Gifts

- Mechanically simple
- Emotionally difficult
- Beware I.R.C. § 1014(e): No step-up for appreciated property gifted to decedent within 1 year of death if the property subsequently passes to the donor or the donor's spouse.

Swap for Low-Basis Assets of Grantor Trust

- Swap has no income-tax consequence.
- No (immediate) effect on gross estate.
- Increases amount of built-in gain that will be eliminated upon death.

- Availability of technique depends on prior planning.

Undo Prior Estate-Exclusion Planning (Cautiously)

- Can you subject trust assets to inclusion?
  - Can the donor assume an office?
  - Can the tax characteristics be changed by modification or decanting?

- Eliminate estate-tax discounts on family limited partnerships?
  - Unwind
  - Eliminate state-law liquidation restrictions by converting to general p'ship.[1]
  - Use IRS's arguments as a sword.[2]

1 Paul S. Lee et al., *Putting It On & Taking It Off: Tax Basis Management Today (for Tomorrow)*, at 1-45 to 1-46 (Heckerling 2018).
2 *E.g.*, *Powell v. Comm'r*, 148 T.C. No. 18 (2017).

Other Possible Basis Step-Up Devices (Careful)

- **I.R.C. § 2038 Trusts**, Paul S. Lee et al., Putting It On & Taking It Off: Tax Basis Management Today (for Tomorrow), at 1-25 to 1-26 (Heckerling 2018).

- **Joint Exempt Step-Up Trusts**, Alan S. Gassman et al., *JEST Offers Serious Estate Planning Plus for Spouses—Part 1*, Estate Planning, Oct. 2013, at 3; Alan S. Gassman et al., *JEST Offers Serious Estate Planning Plus for Spouses—Part 2*, Estate Planning, Nov. 2013, at 14.

- **Optimal Basis Increase Trusts**, Edwin P. Morrow III, The Optimal Basis Increase and Income Tax Efficiency Trust (last updated Apr. 2017).

Tactical Planning for Massachusetts Estate Tax

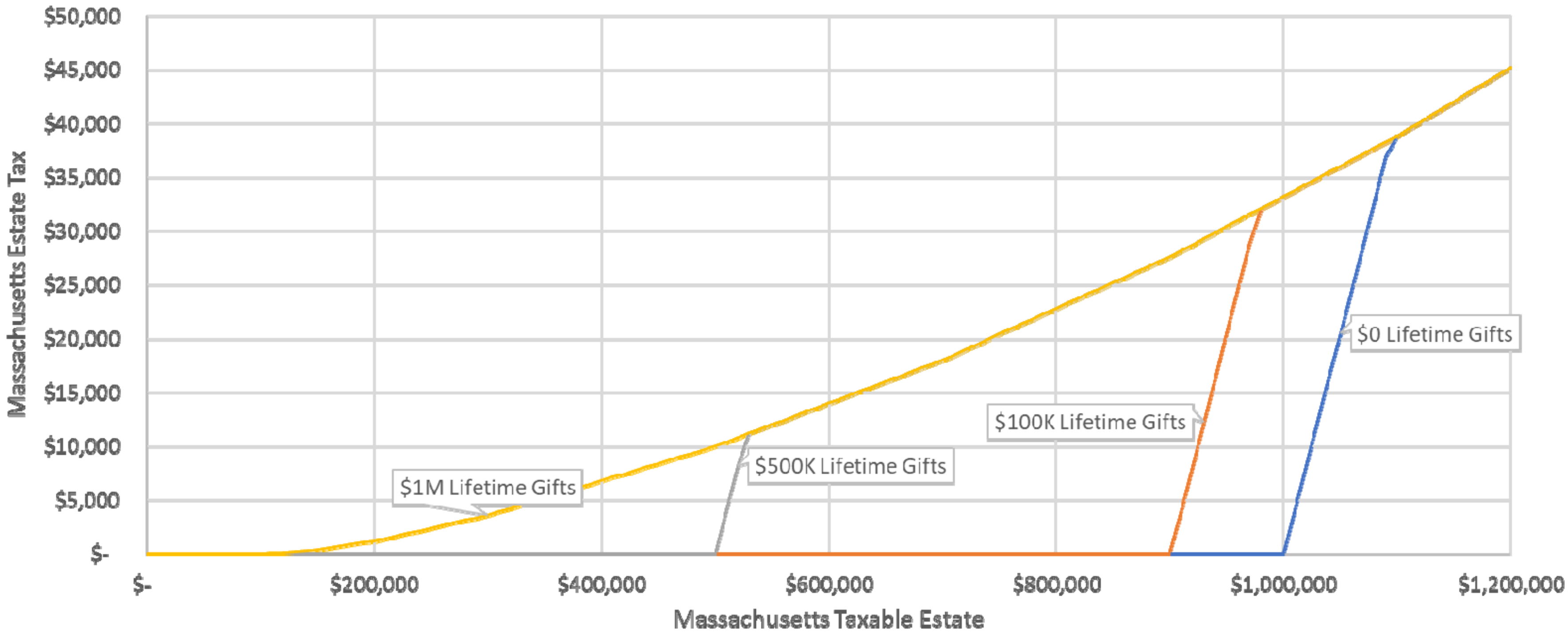
Hemenway & Barnes LLP

Lifetime Gifts

- Pros
  - Removed from Massachusetts taxable estate.
  - No Massachusetts gift tax.

- Cons
  - Lose basis step-up upon death.

Massachusetts Residents Can’t “Gift” Themselves Out of <u>All</u> Massachusetts Estate Tax



Move Tangible Personal Property Out of State

- Easy to do.
- Narrow circumstances.

Change Domicile

- No bright-line test.[1]
  - Compare the "bright-line" income-tax rule of inclusion.[2]
- Common law rule:
  1. physical residence with
  2. intent to remain permanently or indefinitely.[3]
- Burden of proof at least generally on the taxpayer.
- Fact intensive—e.g.,
  - family relations,
  - business activities,
  - social activities, and
  - health care.[4]
- Still subject to tax on Massachusetts-situs real and tangible personal property.

1 *See generally* G.L. c. 65C, §§ 2A & 1(i).
2 G.L. c. 62, § 1(f).
3 *E.g.*, *Devens v. Commissioner of Revenue*, Mass. ATB Findings of Fact and Reports 2012-1001, 1028 (income tax case).
4 DOR TIR 12-10, at III.

Gift of Income Interest in Mass.-Only QTIP[1]

- Federal taxable gift of income interest only.
  - I.R.C. § 2519 does not apply.
  - Low federal gift-tax "cost."
  - No Massachusetts gift tax (but possible effect on quasi-exemption remaining).

- Balance remaining at death not included in taxable estate.

1 Harry F. Lee, Hemenway & Barnes LLP