Estate Planning Without a Net

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We said it couldn’t happen, but the impossible occurred at the end of 2009 with the lapse of the federal estate and generation-skipping taxes. Of course, Congress had its hands full in December with the completion of the Health Care Reform bill, but the Senate did not have the votes (then or now) to pass the estate tax extension at the 2009 levels (an exemption of $3.5 million and maximum rate of 45 percent) to avoid filibuster.

DEVELOPMENTS
Despite promises to address this in January by some Democratic leaders, nothing much has transpired. The Bill to raise the debt ceiling had the added language of the PAYGO (pay as you go) provision that would require offsets for any new tax cuts. The federal estate tax was exempt from this rule, but only to the extent of the 2009 level of tax. Simply put, any increase in the exemption above $3.5 million and any decrease in the rate below 45 percent would have to be supported by revenue offsets. There was some talk about placing the estate tax extension in the Jobs Bill, but this lost traction. It could be added to a budget reconciliation package along with other tax extenders (and maybe Health Care Reform), but this approach appears unlikely.

WHAT IS THE STATUS FOR 2010?
The estate-planning waters run deep and murky for 2010. The status of the law currently is:

- Federal estate taxes do not exist for decedents whose death occurs in 2010.
- Estates for death occurring in 2010 will pass assets under a modified carryover basis system where $1.3 million of basis can be added to qualifying assets with an additional $3 million of basis added to assets passing to a surviving spouse.
- Generation-skipping transfer taxes (GST) do not exist for taxable events in 2010.
- Taxable gifts have a $1 million exemption (applied cumulatively), and gifts that exceed this lifetime exemption will be taxed at 35 percent in 2010.

But, not so fast. There has been a lot of talk from legislators and practitioners that the 2009 rules will be reinstated retroactively. Attorneys, including yours truly, have researched old cases to determine whether retroactive taxation could pass a constitutional challenge. It appears that this challenge could be overcome if the government imposes retroactive taxation under a pressing need for revenue. On the other hand, there are certainly decedents from the first part of this year whose estates would already have standing to challenge any retroactively imposed federal estate tax. This means that we potentially have no certainty with any planning this year before or after the tax reform passes.

WHAT ARE THE POSSIBILITIES?
Your professor directs you to write the following on the blackboard 500 times: “Anything is possible.” After Congress failed to address this on a timely basis prior to the end of 2009, there appears to be no limit to the amount of confusion, procrastination and political maneuvering that will ensue before high net-worth clients have a safety net. I would like to provide some of the more likely choices on the menu and encourage the reader to telephone, write or e-mail your Senators and Congresspersons and let them know your opinion.
• The law could simply perform as enacted leaving us with repeal and modified carryover basis for this year. In 2011, there would be a return of the federal estate and GST taxes with a $1 million exemption with a maximum rate of 55 percent (5 percent more if the estate falls in the surcharge range).
• The estate and GST taxes could be reinstated retroactively at the 2009 levels of exemption and rate, or maybe with a compromise resulting in a higher exemption (perhaps $5 million) and a lower rate (perhaps 35 percent).
• The estate and GST taxes could be reinstated prospectively, providing a windfall only to decedents fortunate enough to die during the brief repeal.
• The modified carryover basis could be repealed and the basis step-up reinstated to prevent the compliance nightmare for an executor to determine the basis and report it to beneficiaries.
• The law could perform as enacted and a compromise could be reached in 2011 to keep the system from the full reinstatement of 2001 tax levels scenario.
• The repeal and modified carryover basis could be made permanent.

A number of political issues will affect this result. Will this be done during a pre-election period? Will a lame duck Congress address this between the election and the end of the year, or will a new Congress deal with this in 2011? What will be the impact of the elections? One constant for the time being is the President; he holds veto power over changes that don’t meet his approval.

WHAT SHOULD BE DONE?
There are a number of recommendations that I can make to be considered in the appropriate circumstances. Some of the planning is risky and complex, and it is important that a team of competent advisers be assembled to formulate and implement any estate-planning steps.

Recordkeeping and Compliance. There is a possibility that modified carryover basis will exist for some period of time. This would not be a good time to clean out the filing cabinets and destroy records. The compliance with carryover basis will require more responsibility on the part of the IRS, the taxpayer, advisers and financial institutions to maintain, report and scrutinize data that affects the income-tax basis of assets.

Plan and Document Review. The uncertainty and multiplicity of possibilities for the federal estate tax makes the periodical review of estate plans imperative for any plan that included tax planning through formula wills or living trusts. All of these documents created marital and credit (exemption) shares that were funded by a formula that would fund the credit trust to the extent such funding will not increase the federal estate taxes. Without a federal estate tax, most of these plans would avoid funding the marital share entirely because the amount that could fund the credit trust without increasing the federal estate tax would be unlimited. This might be addressed by a simple added clause that would apply the formula as if the 2009 estate tax law was in effect at the time of death. Some states have taken action (or are considering action) to solve this problem with legislation to address the interpretation of the documents with their original (pre-repeal) intent. Personally, I would also prefer the client to take proactive steps to address issues in the documents rather than relying on state law.

Many plans for high net-worth testators would also contain directions concerning the application of the GST exemption. Without a GST, these clauses would be ineffective at best, and may cause ambiguities with respect to the administration of the estate.

The possibility of a modified carryover basis would indicate some careful thought and redrafting of wills to address the executor directions and powers with respect to basis allocation of the additional $1.3 million permitted under current law. These decisions could favor one beneficiary over others, and could potentially subject the executor to disputes and challenges. The will could contain language to limit the executor’s discretion and exculpate the executor from liability to the extent discretion is exercised.

Despite the problems created by the uncertainty concerning the repeal of the estate and GST taxes, the time-proven goals of estate planning will not change. The primary concern is to answer the who, how and when questions appropriately
with respect to family wealth and beneficiaries. Tax minimization has always been secondary and is only one of the threats against family wealth. Do not rush to eliminate trusts from the estate plan and simplify documents solely because there may be no transfer taxes.

Life insurance will soften the blow and give the executor the flexibility to sell the real estate and enhance the probability of receiving full value.

Potential Gifting Opportunities. There is no question that appropriately structured lifetime gifts are the most effective estate-planning strategy. Currently, there is no GST and a 35 percent gift tax rate (or maybe not). Someone with high net worth may have a once-in-a-lifetime opportunity to make a large wealth transfer to children and grandchildren and avoid the estate and GST taxes when they are reinstated. The only problem is the distinct possibility that the window of opportunity is limited or may slam shut retroactively, resulting in immediate transfer taxes if the gift is already complete. There are mechanisms available to take a wait-and-see approach. The simplest approach is to make the large gift in trust that otherwise qualifies for the marital deduction under the so-called QTIP rules. The remainder will go to a dynasty GST trust. If the taxes are not reinstated retroactively, the donee spouse can disclaim his or her interest in the trust up to nine months after the initial gift to complete the gift to the dynasty trust at a 35 percent rate. If the taxes are reinstated, the spouse does not disclaim and the donor can take the QTIP election on a gift tax return. With extensions, this decision to make the QTIP election does not have to be made until October 15, 2011.

Taking Advantage of Economic Conditions. There has been discussion to limit certain gift and estate-planning techniques. For example, one proposal would prevent grantor-rentained annuity trusts (GRATs) from having short terms. The suggested minimum term could be 10 years if this proposal is enacted. The current economic climate with low asset values and interest rates make short-term GRATs a particularly effective gift-planning tool. It would be extremely advantageous in some circumstances to take depressed-in-value assets (e.g., investment real estate or securities) and make transfers through short-term GRATs.

Other opportunities using the low interest rates and depressed asset values (and possibly 35 percent gift tax rates and no GST) include charitable lead annuity trusts (CLATs), sales to intentionally defective grantor trusts (IDGTs) and private annuities.

Life Insurance. Life insurance remains essential for liquidity purposes and for wealth replacement. Liquidity has never been more important than under the current economic climate. Estates with any significant real estate holdings will probably be unable to sell the real estate at anything near fair value in the short term. Life insurance will soften the blow and give the executor and the heirs the flexibility to sell the real estate with deliberation and enhance the probability of receiving full value. Under all possibilities outlined above, there will be a potential tax shrinkage facing estates. There will either be an estate combined with potential GST tax on high net-worth estates ($3.5 to $5 million) or capital gains taxes caused by the modified carryover basis on somewhat smaller estates (more than $1.3 million). Most of us feel that capital gains rates will rise above the current 15 percent in the relatively near future with the government’s need for revenue. In either event, the irrevocable life insurance trust (ILIT) remains the most perfectly equipped vehicle to deliver liquidity and wealth replacement.

FINAL THOUGHTS
The current unprecedented uncertainty combined with potentially unique temporary estate-planning opportunities indicates serious consideration of these issues by high net-worth clients. The opportunities discussed here are not without risk and it is more important than ever to bring the appropriate professional resources to the planning table. Working with a competent team focused on the client’s goals will provide the highest likelihood of success.

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Log on to TheWealthChannel.com and view Ted Kurlowicz, J.D., L.LM, CLU®, ChFC®, CAP® and Connie Fontaine, J.D., L.LM, CLU®, ChFC®, CAP® continue the discussion on potential upcoming estate-tax changes.