By Avi Z. Kestenbaum, Jeffrey A. Galant & K. Eli Akhavan

The State of Estate Planning

How the new law influences the way we practice now and in the future

On Dec. 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the Act). The Act significantly impacts the estate planning that advisors will recommend to their clients, as well as the way planners will practice now and in the future. This article briefly describes the Act's key estate, gift and generation-skipping transfer (GST) tax changes, since many other *Trusts & Estates* articles have previously covered these topics. Our focus is on the Act's current and future influence on estate planning practices.

Key Act Provisions

Estate tax. The Act retroactively reinstates the estate tax as of Jan. 1, 2010, but increases the exemption amount from $3.5 million to $5 million and lowers the maximum tax rate from 45 percent to 35 percent. Internal Revenue Code[1] Section 1014's "step-up or down to fair market value" at death basis provisions were also restored. Moreover, the Act offers estates of decedents who died in 2010 the option of electing out of the estate tax regime (no federal estate taxes imposed) and into the modified carryover basis system.

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Gift tax. Under the Act, the maximum gift tax rate is 35 percent and the lifetime exemption amount is $1 million for gifts made in 2010 as it was under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). For gifts made in 2011 and 2012, the maximum gift tax rate remains at 35 percent, but the exemption amount increases to $5 million, thus reunifying the gift tax with the estate tax for the first time since the enactment of EGTRRA.

Donors can still apply their annual gift tax exclusion if the requirements are met[2] (before having to use any part of their $5 million exemption). For 2010 and 2011, the annual gift tax exclusion remains at $13,000 per donee (married couples may continue to split their gifts with the filing of a gift tax return). (For more information on the estate and gift tax provisions, see "New Rates, New Exemptions, New Gifting Opportunities," in the February 2011 issue of *Trusts & Estates*, p. 20.)

GST tax. The Act restores the GST tax for 2010, but with a zero tax rate and a $5 million exemption. In 2011 and 2012, the exemption remains at $5 million with a tax rate of 35 percent. (For more information on the Act's GST tax exemption provisions and their implications, see "Generation-skipping Transfer Tax," in the February 2011 issue of *Trusts & Estates*, p. 30.)

Portability. The Act also provides "portability" between spouses of the $5 million (gift and estate tax, but not GST tax) exemption for estates of decedents dying in 2011 or 2012. Generally, portability allows the surviving spouse to take advantage of the unused portion of the predeceased spouse's exemption (without the need for a bypass trust).[3] To preserve the predeceased spouse's unused exemption, the executor of the predeceased spouse's estate must file an estate tax return and make an affirmative portability election even if the estate

tax return would otherwise not have been required to be filed. (For more information on the Act's portability provisions, see "Bypass the Bypass Trust?" in the February 2011 issue of *Trusts & Estates*, p. 24.)

General Observations

The Act's estate, gift and GST tax provisions greatly benefit taxpayers because of the higher $5 million exemptions and lower 35 percent tax rates. Additionally, the Act resolved several technical estate, gift and GST tax issues favorably to taxpayers (for example, for decedents dying and GSTs in 2010).

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But, the Act is a temporary fix. It creates short-lived rules that will sunset on Dec. 31, 2012. If Congress fails to act before that time, the 2013 estate, gift and GST tax rules will revert to the law in effect prior to EGTRRA (that is, $1 million estate and gift tax exemption and 55 percent maximum estate and gift tax rate; a 55 percent GST tax rate; and a $1.34 million GST tax exemption, as adjusted for inflation). It's impossible to predict what will happen with these transfer taxes after 2012. Possibilities run the gamut from total repeal of these transfer taxes to clawbacks of tax if the exemption is less than $5 million and there are adjustable taxable gifts from prior years.

The increased exemption provides an unprecedented opportunity to move substantial amounts of wealth out of the taxable estate over the next two years. The estate tax is now truly a "voluntary" tax since, with proper lifetime planning, few estates will pay it due to the high exemption amount.

Additionally, given the current low interest rate environment, favorable asset valuations due to a slowly recovering economy and the continued use of family entity discounts, there should be a staggering number of "freeze" and "leverage" transfer techniques, such as family limited partnerships (FLPs), grantor retained annuity trusts (GRATs), charitable lead annuity trusts, freeze partnerships, sales to grantor trusts, private annuities, self-canceling installments notes and intra-family loans implemented over the next two years. The increased lifetime exemption also simplifies the implementation of the 10 percent trust seeding, which is recommended for some of these techniques to avoid thin capitalization issues. It's noteworthy that the Act doesn't impose a mandatory 10-year duration for GRATs and limitations on valuation discounts for family entities and passive investment companies despite recommendations by the current Obama administration and proposed legislation seeking to address these items. If enacted, these changes would have greatly inhibited planning.

Planning and Drafting

Planning will differ depending on the value of the client's assets: (1) $10 million and under in value, and (2) more than $10 million in value.

Clients with assets valued at $10 million and under. For these clients, simple lifetime gifts to trusts and other modest planning can eliminate future estate taxes even if these assets later significantly appreciate in value. In fact, each spouse could even create a discretionary trust for the benefit of the other spouse and her descendants so long as the reciprocal trust and the step transaction doctrines are avoided. While this lifetime planning may seem like a "no-brainer," it might not always be advantageous because if the assets are transferred during lifetime, the future step-up in basis will likely be lost. This loss of the step-up must be weighed against the benefits of removing the assets and all future appreciation from the estate and the asset protection benefit of trusts. Additionally, clients who reside in a state like New York, which doesn't impose a state gift tax but has a state estate tax, gain an additional benefit by transferring assets during lifetime.

Due to the potential loss of the step-up and the availability of portability, some planners may be tempted

to discourage clients from making lifetime transfers. However, this might be imprudent advice. While portability exists today, under the Act it won't be available in 2013 nor will it help with the GST tax or with assets that are appreciating in value. Portability neither provides the asset protection of trusts nor the guarantee that clients' wishes will be fulfilled, especially in the situation of a second marriage or blended family. The skilled and creative planners will be devising plans that encourage lifetime transfers, like the aforementioned spousal trusts, with the possibility to still achieve the later step-up in basis if desired through flexible and perhaps later added powers of appointment, distribution of trust assets by the trustee to the spouse beneficiary at some point before death or the ability for the transferor to later reacquire (power of substitution) assets. Also, some scholars believe the step-up in basis of the transferred assets upon the death of the transferor is still achieved with a technique like a sale to a grantor trust.[4] Therefore, smaller estates might still implement a sale to a grantor trust for the possibility to achieve the later step-up, even though it would otherwise be unnecessary to avoid estate taxes and simpler techniques are available (the specific planning techniques are beyond the scope of this article).

Furthermore, clients with assets valued at $10 million and under who decide not to take advantage of significant lifetime transfers must have wills that are flexible enough for the executor to claim either the full federal estate tax exemption (that could cause a state estate tax if the state exemption is lower) or the state estate tax exemption and the election of portability for the remaining federal exemption (assuming death occurs in 2011 or 2012 or portability is still an option in later years).

For example, will drafting options may include flexible disclaimer provisions so the surviving spouse will be able to decide the amount with which to fund the bypass (credit shelter) trust. Alternatively, the bypass trust could automatically be limited to a potentially lower state estate tax exemption amount so no state estate taxes would be imposed, and if it makes sense at the death of the first spouse, the executor can always elect not to convert the entire marital trust to a qualified terminable interest property (QTIP) trust so more federal estate tax exemption can be utilized and force the payment of some state estate taxes. Another drafting possibility is utilizing a *Clayton* QTIP trust, which would provide that the portion of the marital trust over which the QTIP isn't elected becomes part of the bypass trust.[5] Also, some states allow state-only QTIP elections. While disclaimer provisions may provide maximum flexibility, the disclaimer rules must be followed precisely to achieve success and some planners are reluctant to rely upon the surviving spouse to follow through.[6] Even more complicated is drafting for blended families and second marriages, in which disclaimer planning may be inappropriate.

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Clients with assets valued at more than $10 million. For these clients, it would seem imprudent not to implement significant lifetime planning and transfers in 2011 and 2012. However, clients must also weigh this planning against the potential loss of the step-up if the assets have a low basis and might be subject to recapture at ordinary income tax rates or have significant negative capital accounts (though there are techniques that might alleviate these concerns, which are beyond the scope of this article).[7] Whether to make lifetime transfers is now a much more nuanced and artful decision than it was in prior years since the estate tax rate is only 35 percent, and federal and state income tax rates are likely to increase in the near future. Clients should also consider the impact of a later GST tax if the assets aren't transferred and appreciate in value. Estate planners will have to use their calculators and Excel spreadsheets like never before and work even more closely with their clients' accountants and financial

advisors. The calculations will also have to be factored on an asset-by-asset basis to determine which assets to transfer and which to retain.

Consideration of whether to implement lifetime planning and the drafting of will and trust provisions is further complicated by the Act's sunset in 2013 and the restoration of the 2001 law in effect prior to EGTTRA. Estate planners should draft their documents with enough flexibility to handle the potentially changing rules. Many clients are already confused and frustrated and won't want to update their documents every few years. Additionally, estate planners may have concerns if they fail to properly advise their clients of necessary document changes, or conversely, make reflexive and not well thought-out changes to plans and documents that are only helpful and relevant for this short two-year period.

When did estate planning become only about estate, gift and GST taxes?

The uncertain political landscape causes additional complexities. If the Republicans gain control of both houses of Congress and the presidency within the next few elections, the federal estate tax might be repealed entirely. However, if the Democrats control Congress and the presidency, the estate tax laws could be strengthened again (though even the Democrats would seem unlikely at that point to re-energize the estate tax). Furthermore, while estate, gift and GST taxes comprise only a minimal part of federal tax revenue, the state of the overall economy in future years will also impact the status of these tax laws. It should be noted, however, that perhaps the most important rationale for the estate tax has less to do with revenue and is more grounded in socio-economic reasons such as wealth re-distribution and preventing family quasi-oligarchies.[8] Also, a gift tax may always be necessary to prevent the shifting of the tax burden to individuals in lower income tax brackets.

The Big Picture

No doubt that for the next two years, estate planners will be inundated with drafting plans that take advantage of current laws and are flexible enough to deal with changing circumstances. They'll also be very busy working closely with their clients to help them navigate through the planning complexities and confusion that the new laws have created. The next two years will be the most hectic time in the recent history of estate planning. However, at the same time, it's disconcerting to realize that federal estate taxes now affect fewer individuals and the tax has been significantly weakened, which perhaps sets the stage for future repeal.

This may be an opportune time to recognize that estate planning is hardly just about estate taxes and that estate planners don't simply advise clients on gift, GST and estate tax issues, but rather are important tax, family and business counselors and advisors.[9] Their clients turn to them for advice on both tax (including all types of excise and income taxes) and deeply personal family issues and business and succession planning.

Estate planning is wealth and asset preservation advice and structuring. It's a multi-disciplinary practice and encompasses a wide variety of complex subjects, including but not limited to: asset protection; many types of excise, state, local, income, partnership and corporate tax planning; probate and estate administration; charitable giving; retirement planning; elder law; international tax and estate planning; special needs planning; business and succession planning; and planning to minimize family, estate and partner disputes and conflicts, and if and when disputes occur, the ability to mediate and mitigate the effects.

Estate planners are all aware that over the next few years, state and federal income tax rates are likely to rise, estate disputes will increase and the importance and relevancy of international tax and estate planning will continue to grow. Their clients also appreciate immediate income tax savings more than future estate tax savings, which doesn't benefit them directly when they're in their graves. Furthermore, estate disputes have the potential to wreak far more havoc, both economic and emotional, than estate taxes and estate planners

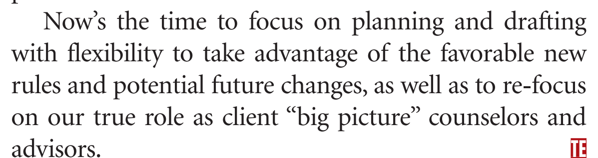
must become more understanding of family dynamics and psychology to help prevent disputes, as well as to deal with family issues.

A shift might also occur to the former practice of attorneys readily accepting the role of executor and trustee if the planning business is significantly diminished, such as in the case of a future estate tax repeal. While this practice might be tempting, we caution against attorneys accepting these roles without careful thought, since attorneys are subject to a higher standard of care. Attorneys may not always be properly trained for these roles nor always possess the requisite administrative capabilities. We note that some attorneys have the requisite training, experience and administrative capabilities to serve as fiduciaries, but these rules are sometimes better left to experienced corporate trustees.

When did estate planning become only about estate, gift and GST taxes? Perhaps this is a time to reflect and focus on helping clients beyond these three transfer taxes and become true "estate planners."[10] We recommend that all estate planning attorneys be well-versed in the other areas so we can become "big picture" thinkers, planners and advisors. In fact, historically and well before the advent of the FLP and GRAT in recent years, estate planners were perhaps even more important to their clients as business, income tax, family and probate counselors and the extreme focus in recent years on minimizing estate taxes has diminished their more important role and hindered their focus.

Instead of concentrating on particular estate planning techniques and forcing their clients into these same techniques over and over again, estate planners will now be compelled to focus on each individual and unique client. They will become better and more effective estate planners. In fact, this article's authors have been writing and lecturing concerning this multi-disciplinary approach for the last few years.[11] Let's immediately stop pigeonholing this generation as well as the next generation of estate planners who are now being trained. Sure, it's difficult to be well-versed in so many specific and complex areas within the estate planning field. However, if estate planners truly care for their clients and their profession, it should be more difficult and upsetting to realize their clients may not be receiving proper counsel if estate planners aren't "big picture" thinkers and advisors.

Now's the time to focus on planning and drafting with flexibility to take advantage of the favorable new rules and potential future changes, as well as to re-focus on our true role as client "big picture" counselors and advisors.



Endnotes

1. All statutory references are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.
2. IRC Section 2503(b).
3. Special rules apply to decedents with multiple prior spouses.
4. *See* "Beyond the Basic Freeze: Further Uses of Deferred Payment Sales," 34th Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Chapter 16 (2000); Jerome Hesch and Elliott Manning, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Mgmt. Estates, Gifts & Tr. J.* 3 (1999).
5. *See* IRC Section 2056(b)(7); Treasury Regulations Sections 20.2056(b)-7(d)(3), 20.2056(b)-7(h), Ex. 6; *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992).
6. *See* Avi Z. Kestenbaum and Kevin Ghassomian, "Use Disclaimers to Add Flexibility and Hindsight to Estate Plans," *Practical Tax Strategies* (June 2006).
7. *See, e.g.*, Laura Blasberg, "Freeze Partnerships—An Alternative to Installment Sales to Grantor Trusts," *Journal of Real Estate Taxation* (3rd Quarter 2010).
8. *See* 53 Congressional Record 11 (1916).
9. Avi Z. Kestenbaum and Rachel D. Mansdorf, "It's Personal," *Trusts & Estates* (April 2009) at p. 23.
10. Jeffrey A. Galant and Dana L. Mark, "Succession, an Attorney's Perspective," *www.wealthstrategiesjournal.com/articles/2008/09/succession-an-attorneys-perspe.html* (2008); Jeffrey A. Galant and Andrew Wilson, "A Primer on Entity Selection for the Estate Planner," *Trusts & Estates* (May 1999) at p. 46; Dana L. Mark and Jeffrey A. Galant, "Estate Planning Strategies Designed for the C Corporation," *Estate Planning* (2006) at p. 18; Jeffrey A. Galant, "ABC's of Foundations: Philanthropy and the Family Foundation," 59 *NYU Institute on Federal Taxation* 19-1 (2001).
11. *See* Avi Z. Kestenbaum, "A Practitioner's Risk Assessment Checklist," *LISI Estate Planning Newsletter* No. 1636 (May 5, 2010), at *www.leimbergservices.com*; Avi Z. Kestenbaum, "Risk Assessment," *Trusts & Estates* (April 2010) at p. 53; Kestenbaum and Mansdorf, *supra* note 9; Avi Z. Kestenbaum and Rachel D. Mansdorf, "True Counselor," *New York Law Journal* (Jan. 26, 2009). Jeffrey A. Galant and Avi Z. Kestenbaum also lecture nationally on succession planning and the multi-disciplinary practice.