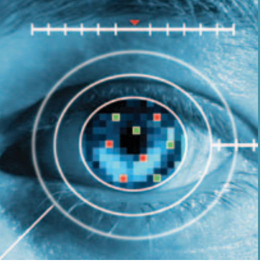


By **Avi Z. Kestenbaum** & **Mary P. O'Reilly**

Planning Beyond the Galaxy of Exemptions

Clients still need help with a diverse range of issues

Under the American Taxpayer Relief Act of 2012 (ATRA), the federal gift, estate and generation-skipping transfer (GST) tax exemptions of $5 million for individuals and $10 million for married couples (subject to an inflation adjustment) were made permanent, as was portability for the estate and gift tax exemptions. As a result of portability and the increased exemptions, it's estimated that less than 0.2 percent of all estates will now be subject to federal estate tax.[1] With fewer clients in need of transfer tax planning, estate-planning attorneys find themselves re-positioning and re-evaluating their practices.

A natural transition for the estate-planning attorney is to elder law. Once considered the poor stepchild of estate planning, elder law is now featured at prominent national estate-planning conferences, such as The Heckerling Institute on Estate Planning—something that would have been unheard of a few years ago. But, before we rush to bifurcate our practices into tax planning for clients with assets above the exemption levels and elder law for clients with assets below the exemption levels, it's important to focus on the various areas of estate planning that have little to do with the size of a client's estate, which remain unchanged and are equally important to all clients—big and small.

What's it All About?

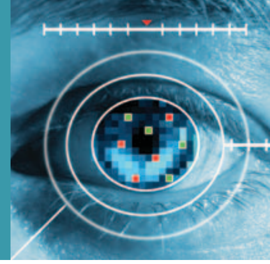
Estate planning is, and has always been, about helping our clients reach their goals. One of the greatest lessons we learned as estate planners was when a prospective client (who's now also a close friend) responded to our request at an initial meeting to list his "assets." The client proceeded to name each of his seven children and 20 grandchildren; not his substantial business and real estate holdings. His family members were his treasured assets and the reason he was engaging in estate planning.

The purpose of estate planning has been described as facilitating "the effective transfer of an appropriate amount of financial assets to succeeding generations of family members in a way that will improve their life course."[2] However, at its most basic level, the fundamental purpose of estate planning is to help clients achieve their wishes—whether that's helping them provide for and take care of their most cherished "assets" or fulfilling their charitable and social missions. Often encompassed within clients' estate-planning wishes is reducing all taxes (not just estate, gift and GST taxes), protecting assets from their future creditors and from the future creditors of their beneficiaries, eliminating estate disputes, promoting family harmony and allowing for the successful transition of family businesses and wealth to the next generation. These necessary areas of estate planning are diverse and require a multi-faceted approach and skilled counsel.

Digging Beneath the Surface

As we're well aware, each client's wishes and goals are unique. In today's information age, clients are better educated and will often come to our offices with preconceived notions of what they want in their estate-planning documents. Our role, however, isn't simply to act as a scrivener memorializing the client's directives on paper. Instead, it requires listening to our clients' stated desires, projecting how they'll play out in the future and inserting our own advice. Our job is to help our clients formulate more

Avi Z. Kestenbaum and **Mary P. O'Reilly** are partners at Meltzer, Lippe, Goldstein and Breitstone, with offices on Long Island N.Y. and in New York City. Avi is also an adjunct professor at Hofstra University School of Law in Hempstead, N.Y.



thoughtful, developed and achievable goals and to use our experience and expertise to help implement them.

To accomplish this task, we must consider the practical and psychological impact of the planning on the client and his family. For example, if a client tells us that he wishes to name his children as trustees of each other's trusts, we should ask the client whether maintaining a good relationship between his children after his death is important to him. If so, the client should consider naming another trustee, so as not to put his children—who may eventually be in different financial positions and have different attitudes towards spending—at odds with each other. Of course, forcing siblings, even ones who may have similar philosophies, to work together may cause all sorts of future issues.

We must also take into account the tax implications and creditor vulnerability of a client's plan. For example, if a client states that he would like his children to receive their inheritances outright at age 30, we should inquire whether he would like a child's divorcing spouse and other future potential creditors to have access to the inheritance and for it to be subject to estate tax in his child's estate. If the client wishes to avoid these potential issues, he should consider naming the child as a co-trustee of his own trust at age 30, with the right to appoint additional trustees or remove and replace his co-trustee with an unrelated party, and giving the "friendly" co-trustee the right to distribute the assets to the child at any time it makes sense to do so.

As illustrated by these two common examples, to be effective estate planners, we must dig beneath the surface of a client's initially stated directives and challenge them. As such, we must be well-versed in both the tax and non-tax aspects of estate planning. We must be able to spot the issues and potential planning opportunities and enlighten our clients as to viable alternatives, including predicting and assessing their chances of success.[3] We need to think outside the box and ask the tough questions. It's our responsibility to bring these skills to the table in advising our clients, and failing to do so puts our planning on par with that of Legal Zoom.

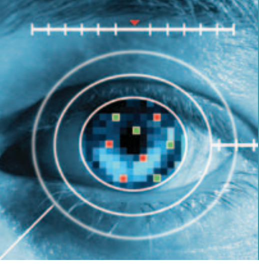
Income Tax Savings

Unlike estate tax planning, for which our clients never personally reap the benefits because they're not alive when the tax savings are achieved, income tax planning is a relief experienced in real time by clients adding money to their pockets each year. As such, clients are, typically, much more willing to pay for guidance to save income taxes, as they personally realize the benefit. This generalization is often true for clients with assets both above and below the federal estate exemption levels.

For example, many clients living in states with high income tax rates, including those clients with a moderate net worth, will move or retire to states, such as Florida, to avoid state income taxes. Helping those clients successfully leave the high tax jurisdiction remains an important role of estate planners. When a client declares, "I am officially a Florida resident, I just filed my tax return," it isn't a fait accompli, but rather a signal to the estate planner that careful planning is needed to ensure the client is in a position to withstand an audit from the state that he's fleeing. Many states, desperate for revenue, don't let their taxpayers go without a fight.[4] Often, residency audits hinge on key facts, such as the number of days spent outside of the state, a change of driver's license and no permanent place of abode in the prior home state, as well as more subtle details, like moving treasured keepsakes to the low tax state, joining social clubs or houses of worship and voting there. Effective communication and advice to the client by experienced counsel helps ensure that a client will be successful in saving on state income taxes.

Many states, desperate for revenue, don't let their taxpayers go without a fight.

Additionally, for those residents of high income taxing states, such as California, New Jersey and New York, who don't want to physically relocate, there are planning opportunities to save on state income taxes through establishing non-grantor trusts for income tax purposes in states with no state income taxes, like Alaska, Delaware, Nevada and South Dakota. Although these trusts are now subject to higher federal income tax rates on ordinary income (39.6 percent after



a modest level of ordinary income, plus the 3.8 percent Medicare tax on unearned income), they typically provide overall tax saving due to the avoidance of state and city taxes. Of course, these trusts don't make sense in all cases. For example, this planning doesn't generally work to save state income taxes for assets, such as real estate, which are physically located in the taxing state, and will be ineffective when beneficiaries living in high tax states require distributions of income, because those distributions will be subject to income tax by the beneficiary's home state if paid out in the year the income is earned. It's the estate planner's role to consider these options and advise their clients of the opportunities to save on state and city income tax when the appropriate situations present themselves.

With the increased federal estate tax exemptions, it's expected that in 2013, only 3,000 estates out of the 2.5 million citizens who pass away will be subject to estate taxes.[5] In addition to the increase of the highest income tax rate to 39.6 percent and the new 3.8 percent Medicare tax described above, under ATRA, the capital gains rate has also increased to 20 percent for most taxpayers, and many deductions have been limited or phased out. As a result, the focus in many estates has moved away from saving on estate taxes and toward minimizing income tax exposure.

From an economic perspective, there are many instances in which an overall tax savings is achieved by leaving an asset in the estate or even transferring it back into the estate to achieve a step-up in basis. In estates with assets below the federal exemption levels, the step-up in basis is very valuable. For the first time, we find ourselves pulling assets back into the estate and turning the Internal Revenue Service's arguments against them to cause estate inclusion on previously transferred assets through claims of retention of income, control and usage and by failing to respect the legal documents and corporate formalities.[6]

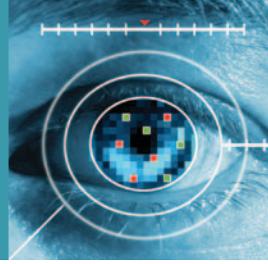
Even for clients with assets above the federal exemption levels, it's necessary to compare the estate tax cost against the future income tax liabilities through the use of number crunching programs (formerly our pencils and calculators). Analysis of the income tax calculations isn't always straightforward, particularly with complicated assets with low or negative bases, such as real estate investments in partnerships and shares of S corporations.[7] And, for those clients who live in states with estate tax exemptions well below the federal levels, such as New York, additional analysis is required, and, quite surprisingly, even in those states, the state estate tax rate is often much lower than the combined federal and state (and possibly city) capital gains tax rates.

Practitioners with clients for whom it doesn't make sense to bring assets back into the taxable estate for the future income tax savings should look for opportunities to maximize the client's ability to get a step-up in basis. For example, practitioners should periodically review previously funded grantor trusts to see if it makes sense for the grantor to transfer cash or other high basis assets to the trust in exchange for low basis assets from the trust. This reversal of the sale to the grantor trust doesn't increase the gross estate, yet ensures a step-up for a low basis asset. Similarly, using joint revocable trusts for married couples should be considered to ensure the estate of the first spouse to pass away will receive a step-up in basis on the entire trust corpus without any increase to the taxable estate.[8]

Planning to avoid estate disputes applies to all estates, regardless of size.

Business Succession Planning

Almost 80 percent of business owners want their families to retain their businesses after retirement, yet very few businesses successfully transition to the next generation.[9] This inconsistency is primarily because of family and relationship issues and has little to do with taxes.[10] As estate planners, we spend most of our energy doing what we're trained best to do—navigating through the tax laws and implementing planning so that the family business won't need to be sold and will legally pass to the next generation. However, we often fail when working with our clients and their key employees to make sure, from an operational and practical perspective, that the business has the greatest ability to succeed in the next generation. Transferring



voting shares and naming a successor manager help address control issues, but they don't deal with the larger and more important business and operational issues, as the statistics prove. Put more simply, what good is our planning if the business fails? With over 90 percent of businesses in the United States considered family businesses, this concept is a vital part of our planning. As estate planners, we should better educate ourselves to understand the reasons most businesses don't successfully transition through the generations and seek ways to help our clients achieve better results with their businesses.[11] Once again, this is about helping fulfill our clients' goals by projecting and thinking through the practical effects of our planning.

Asset Protection

Another area in which the size of the taxable estate doesn't matter is asset protection. With more than 15 million lawsuits filed each year (that's a new lawsuit every two seconds for those of you keeping score at home)[12] and approximately half of all marriages ending in divorce, we should educate our clients on how to protect their own assets and those they pass on to their beneficiaries from creditors. While a larger estate translates into more assets to protect, clients with smaller estates also want to shield what they have against claims of creditors. For example, explaining and recommending flexible spendthrift trusts when your clients wish to transfer assets to their beneficiaries is a simple, yet effective, means of asset protection for beneficiaries.

Similarly, planning to avoid estate disputes applies to all estates, regardless of size. A universal wish of most clients is for their children to get along well with each other. This desire is so strong that many clients would prefer to die penniless, rather than leave their children fighting over assets. As such, establishing an estate plan to minimize disputes should be central to our planning.

Often, simple adjustments may help avoid disputes among beneficiaries. For example, say a client wishes to benefit one child more than the others. Instead of leaving that child a greater portion under the client's will, the client should consider treating all his children equally under his will and benefiting the one child through a lifetime gift or by naming that child (or a trust for that child) as beneficiary of a non-probate asset. With the face of the will showing no outright favoritism to create jealousies, it's less likely the other children will question the will or the overall estate plan, especially if the lifetime transfer happened many years earlier.

With today's increased life expectancies, but not necessarily sustained mental faculties, an increase in contested guardianships and estate litigation is inevitable, and we should strive to help our clients avoid these pitfalls. Currently, one out of four people who are 65 years old today will live past age 90, and one out of 10 from this age group will live past age 95.[13] However, over 5 million Americans have Alzheimer's disease, and over the next three decades, the number of Americans who will have Alzheimer's and other types of dementia will increase by 300 percent to 13.8 million people.[14] Combine this aging demographic with an increase in elder abuse[15] and the fact that we're currently witnessing the greatest transfer of wealth in history, as the baby boomers inherit assets from their parents and make their own transfers.[16] Add into the mix more second and third marriages than ever before (and maybe fourth marriages, if our clients can live long enough) and natural and step-children from these different marriages. The result is an environment rife for conflict, where legal and financial complications abound. To deal with this new reality, the estate planner must not only understand the particular client and family, but also be well-versed in basic psychology and general family dynamics.

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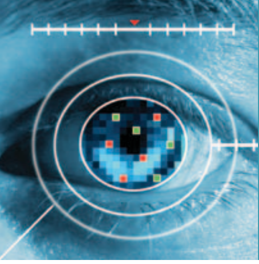
International Planning

The world has been shrinking for years, with growing international businesses, the age of technology and information, ease of travel and clients and loved ones living and working in various countries around



the globe. Foreign bank accounts, as well as business and vacation properties located in different states and foreign countries are common. With new laws and initiatives dealing with offshore accounts and foreign business interests, as well as complex tax rules and reporting requirements, we must advise our clients on how to properly report these assets and provide them with guidance on how to limit their exposure to both income and transfer taxes.[17] This task is especially complicated if we're dealing with several jurisdictions in a given fact pattern, as a structure that works most effectively in one jurisdiction may not work well in another. There will be continued collaboration among professionals in different countries and jurisdictions, and internationally recognized organizations, like the Society of Trust and Estate Practitioners, which currently has over 18,500 members across 80 jurisdictions, will play an even greater role.

Sophisticated non-attorney advisors will continue to play an increased role in the estate-planning process.

Trusted Advisor

Perhaps the most important role of the estate planner is being the client's trusted advisor. This area of estate planning too has no bearing on whether the client has assets above or below the estate tax exemption levels. Often, the estate planner is the person with the most intimate understanding of the client's family, businesses and investments and understands the client's goals and wishes. The client turns to and relies on him for advice—both legal and non-legal. It's due to this relationship that clients often turn to their estate-planning attorney to serve as a fiduciary or as a key decision maker in their estates, trusts and businesses. Corporate trustees are highly valuable for their vast knowledge, resources, expertise, experience, longevity and accountability, but many clients want their personal attorneys to serve separately or, alternatively, to direct their corporate trustees with respect to distributions, legal issues and business decisions.

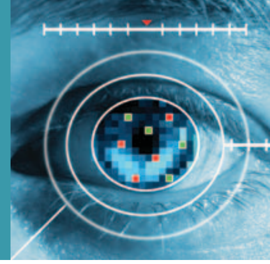
Serving in a fiduciary capacity is a tremendous responsibility both under relevant state laws, such as the prudent investor rules and duties of loyalty, and under an attorneys' moral and ethical obligations to carry out their clients' wishes. Attorneys must carefully fulfill these obligations, while also protecting themselves against claims by their clients' beneficiaries.

The Future

Traditionally, attorneys practicing in the trusts and estates field often specialized in specific areas, such as estate administration, estate planning, federal income tax, taxation of individuals and closely held companies, state and local tax planning, asset protection, international planning, charitable planning and tax-exempt organizations. Today, many law firms are moving away from rigid distinctions in trusts and estates departments towards "personal planning" groups, in which attorneys are well-versed in the many different planning areas in which clients have needs and wishes to fulfill.

There's also a shift in the estate-planning practice away from large firms towards smaller or mid-sized firms. With individual clients (even affluent ones) not wanting to pay the same billable rates as multinational corporations, over the past two decades, many large firms have eliminated or significantly downsized their trusts and estates groups. This movement will likely continue with fewer estates in need of transfer tax planning and more in need of elder law planning.

Sophisticated non-attorney advisors will continue to play an increased role in the estate-planning process. Knowledgeable financial planners, insurance agents and other advisors are becoming increasingly erudite in planning outside of products and investments and providing real value to the estate-planning process. These advisors, who don't generally charge by the hour, are keys to successful estate planning and invaluable to both the client and attorney. The team approach is vital due to all the complexities involved and greatly reduces the potential of missing items and opportunities. Also, as attorneys continue to develop and focus on the various non-tax aspects of estate planning, there will likely be expanded collaboration with other advisors and formal courses offered by consultants to educate and train attorneys in the non-legal, yet vital, aspects of estate planning, such as psychology, dispute mediation and resolution,



business operations and succession and helping attorneys serving as fiduciaries with back office support.

A Multi-faceted Role

Estate planning goes far beyond saving clients estate taxes or helping them qualify for Medicaid benefits. The role of the estate planner is multi-faceted. We must challenge our clients and work with them to develop and achieve their wishes and goals. We must think "outside the box," be knowledgeable and spot the issues in many different areas to guide them properly.

As long as the future brings with it death and taxes, the estate-planning field will remain very active. However, our roles will continue to evolve, expand and become more complex due to the aging population and all the complications that reality brings, greater focus on income tax planning, increased government scrutiny due to advances in technology and need for revenue, general business globalization, increased estate litigations and need for protections and the tremendous transfer of wealth and businesses that we're now experiencing. This is our difficult mission. Should we choose to accept it, it's a tremendous, but rewarding responsibility.

Endnotes

1. *See* Jane G. Gravelle, *The Estate and Gift Tax Provisions of the American Taxpayer Relief Act of 2012*, Congressional Research Service (Feb. 15, 2013), *www.fas.org/sgp/crs/misc/R42959.pdf.*
2. Charles W. Collier, *Wealth in Families*, Harvard University (2006).
3. *See, e.g.*, Avi Z. Kestenbaum, "A Practitioner's Risk Assessment Checklist," *LISI Estate Planning Newsletter* No. 1636 (May 5, 2010), *www.leimbergservices.com.*
4. *See, e.g.*, Timothy P. Noonan, "Where Do You Live?" *Trusts & Estates* (October 2011) at p. 16.
5. *See* Gravelle, *supra* note 1.
6. *See* Internal Revenue Code Sections 2035, 2036 and 2038.
7. *See* Stephen M. Breitstone, "Estate Planning for Negative Capital," *Trusts & Estates* (May 2012) at p. 26.
8. *See, e.g.*, Jonathan G. Blattmachr and Alan Gassman, "Stepping-Up Efforts to Step-Up Basis for Married Couples," *LISI Estate Planning Newsletter* No. 2165 (Nov. 19, 2013), *www.leimbergservices.com.*
9. *See* Michael D. Allen, *Motivating the Business Owner to Act*, SFA2 A.L.I.-A.B.A. 1, at pp. 7-8 (2001).
10. *Ibid.* Only 10 percent of family businesses fail due to the estate tax.
11. *Ibid.*
12. *See, e.g., We All Pay When Others File Frivolous Lawsuits, www.tortreform.com/node/293.*
13. *See www.ssa.gov/planners/lifeexpectancy.htm.*
14. *See* Alzheimer's Association 2013 Alzheimer's Disease Facts and Figures, Alzheimer's Association, *www.alz.org/alzheimers_disease_facts_and_figures.asp.*
15. *See, e.g.*, Dan Sewell, *Aging America, Elder Abuse on the Rise,* (Jan. 27, 2013), *www.nbcnews.com/health/aging-america-elder-abuse-rise-1C8135730.*
16. *See* "The MetLife Study of Inheritance and Wealth Transfer to Baby Boomers," Center for Retirement Research at Boston College for the MetLife Mature Market Institute (December 2010), *www.metlife.com/assets/cao/mmi/publications/studies/2010/mmi-inheritance-wealth-transfer-baby-boomers.pdffootnote.*
17. For example, the Internal Revenue Service Voluntary Offshore Disclosure Programs and the Foreign Account Tax Compliance Act.

SPOT LIGHT

The Promised Land

"Tourism in Palestine/Come See Erezisrael"(26 in. by 18 in.) by Ze'ev Raban, sold for $13,750 at Swann Auction Galleries' recent Rare & Important Travel Posters Sale in New York on Oct. 18, 2013. Raban is actually Polish. He immigrated to what was then Palestine in 1912.