

The “New Normal” of Estate Planning

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What is “normal” for estate planning, given the rollercoaster ride that taxpayers and their advisers have all been dragged on for the past few years? With the TRA 2010 estate tax generosity having only a two-year shelf life, what will be next? Will 2012 become another confusing year of last minute planning and scampering similar to what occurred in 2010—depending on the whether the TRA exemption and rates are extended or changed, perhaps dramatically, yet again? What can taxpayers possibly do to protect themselves?

Is the “New Normal” just a sequence of uncertainty for taxpayers endeavoring to plan some of the most important and financially significant aspects of their entire family’s lives?

Let’s try the Estate Planning New Normal on for size with \$5 million gift, estate and GST exemptions in 2011 and 2012 and a mere 35% rate.

Uncertainty

In 2013, absent Congressional action, a \$1 million estate and gift exclusion (with a \$1 million indexed GST exemption) and 55% rate will again become law. This sounds like the uncertainty of 2010 all over again.

If the \$5 million inflation-indexed exclusion were to remain law, along with portability:

- Very few Americans would ever have to consider the federal estate tax. The vast majority of taxpayers could address and focus on the *nontax* aspects of their estate planning, and perhaps address state estate tax and income tax considerations.
- Ultra-high net worth taxpayers probably should plan aggressively and view 2011 and 2012 as a last window of opportunity. GRATs, discounts, and other planning that had been on the short list for restriction or repeal, remain part of their planners’ toolkit. After 2013, they could be lost along with the generous exemption.

If the \$5 million inflation indexed exclusion is eliminated and the \$1 million exclusion and 55 percent rate were to return:

- Many Americans may get caught in a costly tax. Thus, a significant number of taxpayers should address the potential of a future federal estate tax applying to them.
- Ultra-high net worth taxpayers probably should plan very aggressively for the reasons noted here. The \$4 million dollar question is what happens if these ultra-wealthy clients make \$5 million gifts in 2011; and in 2013 the exclusion drops to

\$1 million. One would believe (hope?) the gifts were “grand-fathered in” and tax man would not appear on their doorstep.

The reality is that many taxpayers will be loath to incur the cost and unpleasantness of sophisticated tax planning. Perhaps these taxpayers should evaluate less costly and simpler techniques that might carry them through the uncertainty. It is certainly advisable for the mere wealthy (i.e. those with substantial net worth but are not in the “ultra” category) to plan now and not wait for what might be adverse tax news in but a few years. For these taxpayers, revising estate planning documents to address the full range of potential tax law scenarios should be a starting point. Perhaps including broad gift provisions in powers of attorney to facilitate future planning is advisable for some. Use of insurance trusts to assure life insurance is outside of a taxable estate if the 2013 year brings stringent estate tax rules is worthwhile. Finally, consider using some of the large \$5 million gift exemption while it is available.

High Net Worth

For the wealthier taxpayers—who might be subject to an estate tax even with the \$5 million exclusion—more aggressive planning, to reduce their estates in advance of 2013, warrants consideration. In particular, the expanded \$5 million gift exemption opens the door to a variety of possible planning strategies. However, those on the cusp of the estate tax with the \$5 million exclusion and portability should plan, as well.

Finally, for the ultra-high net worth families (with \$10 to \$15 million and above), aggressive planning to use the new opportunities of TRA, should be pursued.

Planning Continues to Change Year by Year

It will take some time following the 2010 changes, to sort out the estate and probate implications of the repeal of the estate tax and the modifications of the TRA. Gift tax returns filed in 2011 will have to evaluate any 2010 transactions. Trusts and other planning steps taken in 2010, prior to the TRA becoming law, should all be reviewed and evaluated in light of the new estate tax paradigm and determinations will have to be made as to how to address them. It might be feasible under some early 2010 trusts for a trust protector or other fiduciary to take some type of action that will correct or improve a plan that was implemented without the knowledge of what would eventually occur with the TRA. Some fiduciaries may find that having a court reform a 2010 trust might be advisable. It will take quite some time for the dust to settle on the confusion that was 2010.

2011—2012

TRA brings us new and unexpectedly generous \$5 million gift tax exclusions and GST exemptions. This provides a unique opportunity for those taxpayers with meaningful wealth to use these amounts to leverage large wealth transfer transactions. Since there is

some uncertainty as to what will happen when the two-year TRA extension of the Bush tax cuts ends in 2013, some taxpayers will be inclined to plan aggressively.

A question likely to be asked by taxpayers is that if they fully utilize a \$5 million gift exclusion and then in 2013 the gift exclusion is reduced to \$1 million what becomes of their 2011 and 2012 larger gifts?

The answer is that the estate tax will be calculated on the estate including the gifts and only the \$1 million exemption is allowed. In effect, the estate is not able to keep the benefit of the increased gift exemption. Instead, the general advantage that we have previously enjoyed for gifts remains—the future appreciation from the gift assets is removed from the estate. Furthermore, if the gift is made to a grantor trust, income taxes that the grantor pays on the trust income are also removed from the estate.

Note: The estate pays no more in combined estate and gift taxes than if the gift had not made in the first place. The larger \$5 million gift exemption allows the family to make larger gifts, without any added tax cost, to take advantage of the possibility of removing future appreciation in the gift assets and income taxes paid on grantor trust income. In addition, there is a greater possibility of taking advantage of discounts through the fractionalization of assets by gifts.

For elderly clients that had formed family limited partnerships (FLPs) or family limited liability companies (FLLCs) in prior years to endeavor to reduce their estate taxes, how should those transactions be evaluated in 2011 and 2012?

More Uncertainty

Perhaps the FLPs and FLLCs should be unwound for estates safely under the \$5 million inflation-indexed portable exclusion? After all, if the estate is not taxable, a greater estate tax value of the underlying assets unreduced by discounts will permit a greater basis step up for what most practitioners believe will eventually be higher income tax rates. Perhaps in a similar manner, those taxpayers who set up Qualified Personal Residence Trusts (QPRTs) might now find it advantageous to forgo a written lease and fair rent following the QPRT term, so that the residence could be *included* in the taxable estate of the parent and gain a step up in tax basis, with no estate tax, as a result of the \$5 million estate tax exclusion. It is unclear how the IRS will view such “reverse engineering” tax planning.

But, if 2013 brings with it a \$1 million exclusion and 55 percent rate, unwinding previous planning to take advantage of the 2011 and 2012 law may prove terribly costly.

2013

Here we go again! In 2013, the estate tax rules that were in effect before the generosity of the TRA are back. EGTRRA's \$1 million exclusion and 55 percent rate return. This sounds like a replay of *The Return of Freddy Krueger*.

While many tax advisers would probably wager, with good odds, that the \$1 million exclusion will never return, these are the same advisers that assured clients that the estate tax would never be repealed!

No one really has a clue whether Congress will bring back a \$1 million estate, gift, and GST tax exclusion, retain the \$5 million TRA exclusions, or even repeal all transfer taxes entirely. Perhaps the TRA is a step towards the total elimination of the estate and GST taxes (perhaps retaining the gift tax to backstop the income tax) and instead Congress will simply pass increases in the income tax rates applicable to those earning more than \$250,000 per year? The possibilities are endless, and the lack of clarity, unfair.

So, How Do You Plan?

Taxpayers need to weigh the cost and hassle of planning aggressively—when it may prove to be for naught—against the potentially devastating tax costs of taking inadequate tax-minimizing steps during the 2011 to 2012 window of opportunity. And, that window of opportunity may not even be opened particularly wide for the full two years. If interest rates ratchet up as the economy recovers or other external events push them up, many of the interest-sensitive estate tax planning techniques will lose their luster. The old adage “Good things come to those who wait” doesn’t apply to tax planning, and it is certainly the wrong perspective on the estate tax now.

Estate Planning Redefined

For most taxpayers, estate planning needs to be redefined. Most taxpayers were never subject to the estate tax, but given the publicity the evil death tax received, a far greater number *assumed* it would impact them than what the statistics showed. The reverse will likely now be the case.

Most taxpayers will now assume that with the TRA \$5 million exemption, inflation indexing, and portability, the estate tax will never affect them, so they don’t need to plan. For many taxpayers that do nothing, old documents drafted for different laws, may not meet their objectives efficiently. The old documents may even torpedo key planning goals. The myriad other issues that estate planners addressed in the past—asset protection, matrimonial considerations, retirement planning, charitable considerations, life insurance, and more—will all be overlooked if planning is not pursued.

Practitioners need to redefine estate planning *without the tax emphasis*. Clients generally need to understand that state estate taxes, income taxes, and all the other aspects of a comprehensive estate plan are, in fact, what they need. Not a fill-in-the-blank-will from some cut-rate website.

The process needs to be redefined and clients need to be educated. Taxes will remain important. Estate taxes may ultimately affect many taxpayers, but if clients cannot

understand the importance of the process—even if tax planning is not the major issue—they and their loved ones will pay the price.

The wealthiest taxpayers will likely understand that TRA is an opportunity; and that whatever 2013 brings, planning before it arrives will be a far safer alternative.

Remember the Boy Scout motto: “Be prepared.”

Summary

The “New Normal of Estate Planning” seems to be characterized by a few key threads:

- The law will change. Uncertainty is the new norm.
- Flexibility is key. Drafting and planning need to be nimble. Toggle switches that can turn powers on and off when feasible and permissible, flexible formulas with floors and caps, and qualitative statements of intent, to guide through future unforeseeable changes, should be considered.
- Creative planning that can be less costly and invasive, but protects against future tax changes, should be considered.
- For those who are sufficiently wealthy, or might become sufficiently wealthy, more aggressive planning—even if costly and complex—should be weighed carefully and cautiously against the potentially significant, if not confiscatory taxes, that the future may bring. Terms, such as “sufficiently wealthy,” are intentionally vague. Each taxpayer will have to define these based on their personal threshold for future, uncertain, tax pain.

Checklist

The New Estate Planning – What Services and Advice to Offer Clients

Estate tax rules and estate planning remain in flux. The “New Normal” is uncertainty. Here’s how practitioners can plan in this new arena:

- Broaden the scope of what is considered “estate planning.” Integrate considerations of matrimonial, corporate, business succession, coordination of investment planning with tax, estate and other issues. Consider asset location (which entity, trust, or plan should own which assets) decisions, etc. Broadening the scope of estate planning will keep clients motivated to address planning, even if the federal estate tax threshold is so high that they cannot conceive of worrying about estate tax.
- Educate clients as to the ephemeral nature of the recent estate tax changes. Ignoring planning may prove to be a very costly decision.
- Discuss the possibility of both estate tax goal posts when engaging clients in planning discussions: the complete elimination of the estate tax in 2013, and a reduction in 2013 to \$1 million exclusion and 55% rate. A well stress-tested plan should be viable under both scenarios.
- Flexibility is the watchword. Insurance planning can be a great tool to maintain flexibility, often quite inexpensively, until the estate tax rules declare themselves in 2013.
- Self-funded domestic trusts may be a popular tool for mid-range wealth clients, so that they can establish trusts that arguably remove assets from their estate but which permit them to be a discretionary beneficiary.
- Practitioners need to develop lower-cost solutions for common estate planning issues, since clients—without the elixir of potential estate tax savings—will be hesitant to pay comparable costs for those services. Standardization of planning, documents and other steps in creative and flexible ways will be the key.

*Adapted from **Estate Planning After the Tax Relief and Job Creation Act of 2010: Tools, Tips and Tactics**, by Martin M. Shenkman and Steve R. Akers. Available from www.CPA2biz.com.