Report #14 (Thursday, Cont'd)

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This Report contains coverage of the Thursday Fundamentals Session involving While You Wait: The EGTRRA and What to Do While Congress Ponders the Fate of the Estate and GST Taxes
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Estate Planning While You Wait: The EGTRRA and What to Do While Congress Ponders the Fate of Estate and GST Taxes
Thursday, 1/13/05
Presenter: Howard M. Zartisky Esq.

Reporter: Connie T. Eyster Esq.

Mr. Zaritsky thinks that the estate tax will almost certainly be repealed. The House of Representatives has had enough votes for repeal for a long time and now the 60 votes needed in the Senate are almost certainly there.

For planning purposes, however, practitioners should not focus on what might happen but on the law we currently have.

Even if there is a repeal of the estate tax, estate planners will not be out of business. We will still need to plan for non-tax reasons such as creditor protection and there will still be state estate taxes, carry-over basis rules, and income taxation of retirement benefits to worry about.

Note that if you do a QDOT and the estate tax is repealed, you may be paying estate tax when no one else is paying that tax. It may be better to give property outright to a non-citizen spouse and use disclaimers to fund a QDOT if necessary.

The retention of the gift tax is more than a little relevant. Mr. Zaritsky believes that there must be one heck of a compelling situation to justify making a taxable gift now. Note that if a client made $675K worth of gifts before 2001- the client might not be able to make an additional $325 of gifts because of shifting rates. (See p.10 of the materials)

If the estate tax is not repealed, many bills in Congress now seem to suggest that there will be at lease a $5 million applicable exclusion amount.

With regard to carry-over basis rules, Mr. Zaritsky does not think you need to do any detailed planning for it now because even if the estate tax is repealed and we do have carry-over basis, those rules will likely look very different from the ones included in the statutes right now. We should be telling clients to keep better records.

Generally, the EGTRRA carry-over basis rules provide that each individual will have $1.3 million to allocate to basis in his or her estate and $3 million to allocate to basis for assets passing to a surviving spouse. Nonresidents only get a $60,000 basis adjustment. Mr. Zaritsky counsels against using "estate trusts" to obtain the marital deduction, as it might prevent the allocation of spousal basis.

The basis allocation also cannot be given to items carrying IRD. This will be a big issue for people with a lot of retirement plan benefits.

Note that substitution of carry-over basis for an estate tax will greatly increase the taxes on the surviving spouse.

Mr. Zaritsky thinks the repeal of the state death tax credit has an enormous impact on estate planning. There is a wide variety of rules out there right now. Practitioners must have a detailed list of the location of a client's assets, both tangible and intangible, before suggesting planning.

Note that, in Florida, the bar has suggested that it is unethical for an attorney from another state to provide advice on Florida state estate tax laws. If other states follow this rule, then it may be necessary to get formal opinions from local counsel when working with a client who has assets located in a state that has a state death tax.

With regard to testamentary planning, Mr. Zaritsky suggested that you may want to put alternative dispositions in your wills, which would take effect if the estate tax is repealed. However, he suggests only including such alternate dispositions if it is relatively easy to draft them. For instance, if a client would prefer that there were no marital trust or no family trust in the event that the estate tax is repealed, that would be an easy alternative disposition to draft. In other cases where the alternative disposition is more complicated, it might be worth waiting until actual repeal to deal with those issues.

Mr. Zaritsky next discussed whether we should be doing new planning for smallish estates. For estates where the assets of the married couple are less than the applicable exclusion amount, planners may choose to make no changes. However, as the applicable exclusion amount increases, practitioners should start looking at whether the non-marital share trust is growing too large and whether the failure to fund a marital share will make the surviving spouse uneasy or otherwise cause family tensions.

If the estate is over $1.3 million, but less than the applicable exclusion amount, there may be some opportunity to do carry-over basis planning, but Mr. Zaritsky suggests that he is reluctant to do too much planning here.

For estates between $1.5 and $2 million, Mr. Zaritsky again suggests that practitioners should review the size of the non-marital share trust to determine if it is worth capping it at something less than the full applicable exclusion, either because of family dynamics or because of carry-over basis issues. The problem of over-funding for carry-over basis rules was illustrated by the following example. Imagine an estate of $2 million. If on the first spouse's death, $1.5 million goes into a family trust and $500K is given to a marital share. On the second spouse's death there is no estate tax, but that spouse may have "extra" basis allocation that goes unused and assets distributed to the family trust on the first spouse's death will be stuck with their lower basis. One way to address this issue would be to put a specific provision in your documents allowing the trustee of the non marital share to distribute assets to the surviving spouse outright in order to allocate basis adjustment on the surviving spouse's death.

Whether practitioners decide to create a cap on the non-martial share or not, practitioners should look at their current marital deduction formula and figure out what will happen if there were no estate tax. You need to have a sense of what repeal would do to your documents to know the extent to which repeal should be addressed.

Another technique you might consider is the spousal power of appointment trust, which works as follows: Husband and Wife each establish a revocable trust which provides that upon death the assets will be divided into a marital and non-marital share. If husband dies before wife, he is given the power to appoint the assets of wife's trust to his estate to the extent necessary to take full advantage of the estate tax exemption. This ensures that both husband and wife's assets are included in the estate of the first spouse to die and ensures that the full applicable exclusion amount will be used on the first death.

Note that under current law, the assets that were in wife's trust will not receive a new basis on husband's death, but a bunch of PLR's suggest that is technique works just fine from an estate inclusion perspective. ACTEC has asked the IRS to give us a revenue ruling on the estate inclusion issue.

Mr. Zaritsky also likes the use of a total return trust as a planning technique in this environment. It is a nice way to eliminate fights when we have a very large non-marital share and a 2nd marriage. Note, practitioners should NOT promise beneficiaries that total return trusts will result in greater overall returns. Rather, the practitioner should focus on the family dynamic benefits. Also, Mr. Zaritsky suggests that, administratively, using January 1 as a valuation date is the best approach. With regard to defining the unitrust amount, use of a 3-5% is probably fairly safe.

Mr. Zaritsky also discussed the intersection between carry-over basis and the marital share. One big rule to know is that the $3 million spousal property election cannot be made on property passing to a general power of appointment trust (estate trust), but rather can only be allocated to distributions passing outright to the spouse or to a QTIP trust.

As a practice pointer, Mr. Zaritsky suggests giving direction to fiduciaries in your documents regarding how the basis allocation adjustment should be applied. First and foremost, the fiduciary should be given absolute authority to select which assets get which allocations, and should be exonerated for making basis adjustments that treat beneficiaries unequally so long as the fiduciary is acting in good faith. You may also want to give the fiduciary direction to allocate the basis adjustment first to assets which will generate ordinary income.

With regard to the differences in state death tax exemption amounts â€“ the decoupling can result in payment of state estate tax even when no federal tax is due. The easiest way to deal with this issue is to encourage clients to give away their property held in states where there is a state estate tax. Another planning technique may be to take a tangible asset and contribute it to an entity so that the ownership is now an intangible asset, although there is some question whether that technique will actually work based on applicable state law. One very important issue is to ensure that your client cannot be deemed to have more than one domicile. See p. 132-135 of the materials.

(Note that there is a correction in the materials on p. 137. Paragraph (d) should start "without regard to whether this affects the state estate death taxes.")

One way to address the issue of marital deduction formulas in a state where there is a state estate tax is to create several testamentary trusts as follows:
(a) create one trust that will hold property up to the applicable state exemption (assuming that the state exemption is less than the applicable federal exclusion amount).

(b) Create one trust that has QTIP provisions which Mr. Zaritsky calls the "spousal non-marital share"- that holds the amount of property which is the difference between the federal and the state exemption amounts. You can make a QTIP election for this trust which will be ignored for federal purposes because it is not necessary to make this election in order to reduce the estate tax to zero. See Rev. Proc. 2001-38. The election, however, may be respected for state estate tax purposes because it is necessary to reduce state estate taxes to zero. This technique will not work in a state that does not permit the making of inconsistent elections.

(c) Create one trust to hold the balance as a marital share.

In general, it is best to draft documents to be as flexible as possible. The easiest way to stay flexible is to give the trustee broad powers of distribution. Mr. Zaritsky suggests using an independent trustee and giving the beneficiaries broad powers to remove and replace the trustee.

Mr. Zaritsky concedes that disclaimers allow for a great deal of flexibility in planning, but in his experience, it is too easy for the beneficiaries to destroy this planning option post-death and practitioners would be unwise to rely too heavily on it.

Mr. Zaritsky's preferred flexible planning technique is to place all of the decedent's assets in a QTIP trust and allow the fiduciary to make a QTIP election with regard to some or all of the trust. The downside to this technique is that all of the trust income is distributable only to the surviving spouse.

Another, similar option, would be to put all of the decedent's assets into a "Clayton QTIP," which would permit the trustee to transfer the assets for which the QTIP election was not made to a family bypass trust. This would permit the sprinkling of income for assets not included in a marital share. (See p. 136 of the materials). The downside of this form of trust is that it cannot be used to create shares that are deductible for state death tax purposes but are not deductible for federal estate tax purposes.

In summary, with regard to testamentary planning, practitioners should:
1. Plan with law we have today
2. Plan for the state death tax credit by, to the extent possible, eliminating property held in states with a state death tax credit. If you can't get rid of that property, create different non-marital division for state and federal purposes.
3. Recognize the possibility of carry-over basis principles and authorize the trustee to make distributions of property to take advantage of surviving spouse's basis allocation
4. Use independent trustees and give them authority to revise the trust to accommodate changes in the law.

5. Consider reciprocal power of appointment trusts.

With regard to lifetime planning, Mr. Zaritsky again reiterated that you would need an extraordinary fact pattern to justify making taxable gifts right now.

If a client is making lifetime gifts, an ideal asset to give away now is one that has a low basis but which is unlikely to be sold suchh as an asset with sentimental family value.

Interfamily sales are also ideal transactions during this difficult period. They freeze estate tax values and do not incur a gift tax,

When using discount planning, practitioners should be cognizant that gifting during life throws away the option to allocate new basis at death and if the assets are discounted, you might never be able to get the basis up to fair market value.

Life insurance planning can still be valuable see pages 199-200 oof the materials. Never advise a client to cancel life insurance at the first meeting. Mr. Zaritsky suggests that funds should be borrowed against the policy first, and then terminated if in fact the policy is no longer necessary. He is very hesitant to dispose of a policy we can't replace.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

GENERAL INFORMATION ABOUT INSTITUTE
Inquiries/Registration
Philip E. Heckerling Institute on Estate Planning
University of Miami School of Law
Center for Continuing Legal Education
P.O. Box 248087
Coral Gables, FL 33124-8087
Telephone305-284-4762 / FAX305-284-6752
Web site www.law.miami.edu/heckerling
E-mail heckerling@law.miami.edu
==
Headquarters Hotel - Fontainebleau Hilton
4441 Collins Avenue
Miami Beach, FL 33140
Telephone (305) 538-2000, FAX (305) 674-4607
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