Planning for the 10-Year Phase Out of Estate Tax (with Form)

Paula M. Jones

Is your client's estate plan ready for the changes in the next 10 years?

WHAT ARE PRACTITIONERS DOING to guide estate planning clients through the new provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (hereinafter "EGTRRA '01")? There was a great deal of discussion before its passage regarding the changes this law might inflict upon estate planning clients. Over one year later what changes are truly needed?

LAW BEFORE AND AFTER EGTRRA '01 • The law before EGTRRA '01 set the federal estate tax exemption amount (hereinafter "FETEA") at $675,000 in 2001 and slowly increased it to $1 million by 2006. The new tax law has increased the federal estate tax exemption to $1 million in 2002 and again to $1.5 million in 2004. In 2006 through 2008 the exemption amount will be $2 million, and then $3.5 million

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in 2009. Internal Revenue Code §2010(c), as amended by EGTRRA '01. The estate tax is repealed in 2010, but unless a law is passed to extend the current law, in 2011 the exemption amount returns to $1 million. EGTRRA '01 §901(a)(2).

If a law is passed to keep the repeal in effect, the system of carryover basis will begin. Each individual will be exempt from tax on the first $1.3 million in built-in capital gain and transfers to spouses can avoid an additional $3 million in tax on capital gain.

Before EGTRRA '01, the federal estate tax and gift tax system was unified. However, after 2002 and until 2009, the gift tax exclusion amount will remain at $1 million. §2505(a)(1), as amended by EGTRRA '01. The law also made changes in the generation-skipping transfer tax system.

CASE STUDY: THE RETIRED COUPLE LIVING OFF INCOME • The following case study will be used to illustrate each factor to be reviewed in light of the new tax law.

Marjorie and Karl Olafson have been married for nearly 50 years. They have four children and 10 grandchildren. They have a combined estate of about $2 million and have equalized their estates so that each has assets of about $1 million. Drafted before EGTRRA '01, the Olafsons' estate plan is a basic marital/residuary trust structure. Since the FETEA was $675,000 in 2001, each placed this amount in a residuary trust for the benefit of the spouse at death to shelter a total of $1.35 million. The residuary trust requires that all income be paid to the surviving spouse. As much principal may be withdrawn as needed for ascertainable standards but only as long as the marital trust is no longer in existence. There is a five and five power and the surviving spouse has a limited power of appointment to issue at the death of the spouse. The marital trust is more flexible in that it provides for all income to be paid out currently and as much principal as desired by the surviving spouse—for any reason at all. The surviving spouse has a general power of appointment over the principal of the trust. Almost all of the Olafsons' assets are held in revocable trusts. ABC Bank has been named as Trustee for convenience purposes.

What changes do the Olafsons need in their current estate plans in light of EGTRRA '01? Practitioners should consider the following factors:

Size of Estate

What is the value of the current estate and what is its expected value in each year through 2011? The typical client situations to be reviewed in light of the new law are, generally, those single clients with estates between $1 million and $4 million and married clients with estates between $1 million and $7 million. Since the highest FETEA in 2009 is $3.5 million, those single clients with estates currently valued at over $3.5 million and those married couples with estates currently valued at over $7 million still face the threat of the federal estate tax. Likewise, those clients with estates under $1 million who were not concerned with the federal estate tax before the change in the law are still unaffected by it.

In 2001, with an estate of $2 million and a FETEA of $675,000, the Olafsons were able to shelter $1.35 million from the federal estate tax. Now with a FETEA of $1 million the Olafsons can shelter their entire estate from federal estate tax. The new law has essentially eliminated a federal estate tax burden for these clients for the near future.

Future Size of Estate

Currently, the Olafsons have no threat of federal estate tax. However, in future years, as the FETEA changes, will this threat resurface? The practitioner must look at the assets currently owned by the client and estimate if estate assets will appreciate and surpass any FETEA.

The Olafsons live in a retirement community, so they own no real estate and their interest in the retirement community does not appreciate with time. Their assets consist mainly of a large brokerage account with ABC Bank which is invested mainly for income. The cost of their lifestyle is not expected to increase. Should one of them require long-term medical care, the community in which they live will provide that care without an additional fee. It would be safe to assume that the estate value of the Olafsons will change minimally by 2011.

Residuary Trust Terms

The residuary trust will be funded with the FETEA in the year of death of the first spouse. Consider a cap on the amount passing to the residuary trust. Currently, under the Olafsons' existing plan, the full estate of each spouse is required to pass to the residuary trust. This has been referred to as "disinheriting the spouse." In other words, assets which were owned outright by the couple before the first death will be placed in a residuary trust with some restrictive provisions. Even though the couple was living off income before the death of the first, the survivor should have access to as much of the total estate as needed should an unforeseen financial need arise.

One way to shelter the entire estate from the federal estate tax while providing the surviving spouse with some assets in the flexible marital trust is to cap the amount passing to the residuary trust.

If each spouse caps the residuary trust at $850,000, for instance, this amount is sheltered from the federal estate tax, yet anything above that amount will be available for the unrestricted use of the surviving spouse. Therefore, each spouse will be in complete control of his or her own estate of $1 million plus any amount over $850,000 from the deceased spouse's estate.

Immediate Nonspousal Beneficiaries

Does the current plan leave the exemption amount in the residuary trust to someone other than the surviving spouse? Check to ensure the beneficiaries under the existing estate plan are persons other than the surviving spouse, to prevent the surviving spouse from being disinherited.

Marital Trust Terms

The terms of the Olafsons' marital trust offer so much flexibility that they are comparable to the surviving spouse receiving the money outright. Why, then, should the Olafsons use a marital trust instead of an outright marital gift of all estate assets above the FETEA?

Asset Management

The main reason the marital share was left in trust was so that the ABC Bank could continue to manage the money as usual after the death of the first spouse. The Olafsons have grown tired of managing the family finances. They have developed a relationship with ABC Bank and rely on its management expertise. At the death of the first spouse, the income and principal allocation will remain the same and the standard of living of the surviving spouse will not change. If convenience and asset management are concerns of either spouse, leaving the marital share in trust is an important consideration.

Control of Disposition in Event of Remarriage

Under the existing plan, should the surviving spouse remarry after the death of the first, he or she does have the ability to redirect the marital trust principal at his or her death to the new spouse. At the death of the second spouse, the marital trust principal will pass through his or her estate. One of the reasons for leaving this portion in trust rather than outright in a marital gift is to insure the marital portion will eventually reach the children and not be redirected to a new spouse. Specifically, the Olafsons could use a Qualified Terminable Interest Property trust as the marital portion if the children being shut out is a client concern.

Provide Flexibility for Disposition to Children

The Olafsons know that the amount of the estate of the first to die will pass to the residuary and then on to the children upon the death of the surviving spouse, since the surviving spouse has been given a power of appointment limited to issue. This power does not prevent the surviving spouse from disinheriting one or more of the children, however. The surviving spouse may exercise the power in favor of issue in any proportion he or she deems appropriate. However, the remaining principal in the residuary trust must pass to at least one person who is the issue of the first spouse to die. If the spouse first to die does not want to allow for even the possibility that a child will be disinherited, he or she should remove the power of appointment altogether. The terms of the residuary trust require that it be divided equally to issue as a default. Therefore, he or she does not have the ability to redirect the residuary trust principal at his or her death to someone other than the children—such as a new spouse.

Planning for Client Incapacity

Practitioners can advise clients to update their estate plan as the estate law progresses through the years. However, it is possible that a client will become unable to update his or her plan due to incapacity or incompetence. In this case, the attorney should plan ahead for every contingency in the current law. Since the existing law encompasses increasing exemption amounts, estate tax repeal, carryover basis, and reinstatement of the estate tax, there are quite a few scenarios that may occur through the years. Each one of these should be accommodated in a client's current estate plan.

Powers of Attorney

As a further precaution, attorneys may consider incorporating the client's powers of attorney in the possible changes to an estate plan. A power of attorney can provide that the agent can make changes to an existing trust for the principal's benefit. In this case, attorneys may consider the use of a pour-over will with a revocable living trust, so that the revocable living trust may be changed by the agent. Should the law change again while this principal is incapacitated, the agent can work with the attorney to amend the trust provisions for the client's benefit.

SAMPLE LANGUAGE • The following is sample language of an up-front credit shelter trust incorporating a graded cap depending on the FETEA in the year of death, repeal of the estate tax, system of carryover basis, and reversion to the law before EGTRRA '01:

Credit Shelter Trust

I. I give to my Trustee, in addition to any property received directly by my Trustee that is excludable from my gross taxable estate for federal estate tax purposes, the largest amount, if any, [not to exceed $____________ if I die in 2004 through 2005] [not to exceed $__________ if I die in 2006 through 2008], [not to exceed $__________ if I die in 2009] [not to exceed $_________if I die in 2010] [not to exceed $__________if I die in 2011] which can pass free of federal estate tax by reason of the unified credit against and any other federal estate tax credits except:

(1) the state death tax credit to the extent that the use thereof would require an increase in the amount of state death taxes paid; and

(2) the credit for tax on prior transfers to the extent that credit arises from transfers to me from individuals who die after me;

(A) but excluding the value of all property not qualifying for the marital or charitable deduction and

(B) excluding the value of all charges to principal, including administration expenses, not including death taxes not deducted in computing my federal estate tax (since I direct hereafter that these death taxes be paid from this trust).

II. The calculation above shall disregard any disclaimer by my spouse of property qualifying for the federal estate tax marital deduction, whether in my probate estate or not, or a failure by my executor to make the election under Section 2056(b)(7)(B)(v) of the Internal Revenue Code. Any interest in any property or any portion of property disclaimed by my spouse which, but for such disclaimer, would have passed as part of the marital deduction amount shall be added to this Trust.

III. If I die in a year in which the federal estate tax has been repealed, I give to my Trustee the "aggregate basis increase," as defined in IRC Code Section 1022, as added by EGTRRA '01, as amended.

IV. I recognize that depending upon the amount of bequests under my Will, my nontestamentary dispositions, the amount of state death taxes and administration expenses, the possible repeal of the federal estate tax, and other factors, there may be no Credit Shelter Trust and that the amount, if any, may be affected by the exercise by my Executor of certain tax options.

V. My Trustee shall administer and distribute this trust as follows: ______________________ .

CONCLUSION • By referring to the factors noted here, the estate planning practitioner can insure that each client's estate plan is effective throughout the duration of the new tax law—even if the client fails to make updates as the tax law progresses.

PRACTICE CHECKLIST FOR
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What changes do clients need to make in light of EGTRRA?

- Review the following:

☐ Size of the estate—what is the value of the current estate, and its expected value through 2011?

☐ Cap on the residuary trust amount—should one be in place?

☐ The exemption amount in the residuary trust—is it left to someone other than the surviving spouse?

☐ Marital trust terms—are they flexible enough?

☐ Marital trust principal—can it be redirected by the surviving spouse to a new spouse? Can a power of appointment over the principal be used to disinherit one or more of the children?

☐ Client incapacity—are powers of attorney incorporated into the plan?

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