Estate Planning Insights

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THERE IS NO ESTATE TAX!

As doubtful as it may have seemed previously, we have finally reached the year when, pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001, there is no estate tax (also called the death tax). While reaching this "zero estate tax" year seems favorable, it does not present any planning opportunities because a person has to die in 2010 to achieve this result. Further, if Congress decides to change current law sometime this year and make the changes retroactive to January 1, 2010, then it won't pay to die right now! So, planning discussions, instead, have focused on the new income tax basis provisions (a modified carryover basis regime that applies for decedents who die in 2010) and the fact that there is also no Generation-Skipping Transfer Tax in 2010.

The GST Tax. The Generation-Skipping Transfer Tax ("GST Tax") is a complicated excise tax that is often misunderstood. Two defined terms are important in understanding the GST Tax: the *transferor* is the person making the Generation-Skipping Transfer (either during life or at death) and a *skip person* is a person who is two or more generations below the transferor (or transferor's spouse), such as a grandchild. Unrelated persons who are more than 37½ years younger than the transferor are also considered skip persons under the GST Tax rules.

Basically, there are three types of Generation-Skipping Transfers: (i) Direct Skips, (ii) Taxable Distributions, and (iii) Taxable Terminations. A gift from a grandparent to a grandchild is an example of a Direct Skip. A distribution from a multi-beneficiary trust (such as a typical Bypass Trust) to a grandchild pursuant to a trust provision authorizing distributions to any descendant of the transferor is a Taxable Distribution. A Taxable Termination occurs when a parent creates a trust for her child that terminates when the child dies, at which point the remaining trust assets then pass to the child's children.

The purpose of adding the GST Tax to the federal transfer tax regime was to prevent people from getting around the estate tax by making Generation-Skipping Transfers. As with other federal transfer taxes, Congress provided an exemption from the GST Tax (called the "GST exemption"). Transferors can allocate all or part of their GST exemption to Generation-Skipping Transfers they make during life or at death. From 1985 until 1998, the GST exemption was $1,000,000. Beginning in 1999, Congress added an annual cost-of-living inflation adjustment to this figure. Effective for 2004 and beyond, Congress made the GST exemption the same as the estate tax exemption. Thus, in 2009, for example, the GST exemption was $3,500,000 (just like the 2009 estate tax exemption).

The GST Tax rate is high–it's a flat tax imposed at the highest transfer tax rate. Thus, in 2009, the GST Tax rate was 45%. Keep in mind that since Generation-Skipping Transfers are transfers that implicate either the federal gift tax or the federal estate tax, when GST Tax is owed, it may be paid *in addition to* the federal gift tax or federal estate tax.

Proper use of the GST exemption can avoid both GST taxes and future estate taxes. If "GST exempt" trusts are structured to last for the longest period allowed under the Texas "Rule Against Perpetuities", trust assets can avoid all federal estate taxes and GST Taxes for over 100 years. This results in a much larger amount being available for the health, support, maintenance and education of several generations of the transferor's descendants.

Gift Tax Still Applicable in 2010. As a reminder, even though neither the federal estate tax nor the GST Tax applies in 2010, you can't avoid future estate and GST taxes by making unlimited gifts in 2010. The federal Gift Tax still applies in 2010 (except that the tax rate for *taxable* gifts is 35% and not 45%). Certain types of gifts are considered *tax-free* gifts: *qualified* annual exclusion gifts and *qualified* medical and tuition payment gifts. The annual gift tax exclusion amount for 2010 is $13,000. Thus, the *donor* (maker of the gift) can give to each *donee* (recipient or beneficiary of a gift) cash or other assets during 2010 having a total value of $13,000 or less, free of federal gift tax. In the case of a married couple, since that makes two (2) donors, the total amount that can be given away tax-free in 2010 would be $26,000 per donee.

To qualify for the gift-tax annual exclusion, however, the gift must meet the "present interest" test. Outright gifts to individuals will qualify for the annual exclusion unless the donee is a minor (person under age 18) or lacks mental capacity. For a gift to a minor to qualify as a

present interest, the gift must be in a form authorized by law. The most common ways to make gifts to minors that qualify for the annual exclusion from the gift tax are gifts to custodial accounts under the Uniform Transfers to Minors Act (UTMA) or Uniform Gifts to Minors Act (UGMA) or gifts to 529 plans. Custodial accounts terminate when the child reaches either age 18 or age 21, depending on applicable state law.

Gifts made to most trusts do not automatically meet the present interest test. One exception is a "Section 2503(c) trust", which must be drafted to allow the beneficiary to terminate the trust upon reaching age 21. Because of this "early" termination requirement, most donors do not like using 2503(c) trusts and use *Crummey* trusts instead. With a *Crummey* trust, every time the donor makes a gift to the trust, the beneficiary must be given the right to withdraw the money placed in the trust for a certain period of time (called a *Crummey* withdrawal power). The beneficiary must also be provided with written notice of his withdrawal right to meet the present interest test. Thus, the *Crummey* withdrawal right can also be problematic.

The other exclusion from the federal gift tax applies when the donor pays directly another person's medical and/or tuition bills. This medical/tuition exclusion is *in addition to* the $13,000 gift tax annual exclusion.

Gifts that do not qualify as tax-free gifts are *taxable* gifts. Thus, gifts as small as $100 can be taxable gifts if they don't qualify under the rules described above. All taxable gifts must be reported to the Internal Revenue Service ("IRS") on a U.S. Gift Tax Return (Form 709). There is no statute of limitations on *unreported* taxable gifts, meaning that, even upon the donor's death, the value of these unreported taxable gifts (often influenced by hindsight) is added to the donor's estate tax base for federal estate tax purposes. When a person makes a taxable gift, she is using up some of her $1 million lifetime gift tax exemption amount. In years when there is also an estate tax, taxable gifts simultaneously use up a portion of the person's federal estate tax exemption amount, too. Thus, for two reasons, the IRS requires all taxable gifts to be reported (so that they can be tracked by the IRS): (i) once a donor makes taxable gifts totaling, in the aggregate, $1,000,000, she must pay a gift tax on all taxable gifts made thereafter, and (ii) to the extent of taxable gifts made during life, the donor will have less estate tax exemption available to shelter transfers made at death from the estate tax.

(By the way, the IRS has recently launched a new initiative and hired many new tax examiners to try to catch people who are committing federal gift tax fraud by not reporting taxable gifts.)

In our practice, we see a lot of unreported taxable gifts. If we are representing the Executor of the estate of a decedent who made unreported taxable gifts during life, we must advise the Executor to report those gifts. Note that, under federal law, the Executor of a decedent's estate has *personal liability* for all taxes owed by the decedent.

The most common unreported gifts we see are gifts involving real estate (or undivided interests in real estate). We also see unreported gifts of stock in a "closely held" (i.e., family) business or interests in family limited partnerships (FLPs) or limited liability companies (LLCs). For example, if a parent owns a piece of property (or is purchasing a piece of property) and places his child's name on the title to the property, unless that change in title is structured as a sale at fair market value (i.e., the child is paying fair market value for his interest in the property), putting the child's name on the title to the property is a gift by the parent to the child.

Sometimes people structure such a transaction as a purported sale. This means that the property (or interest in property) being transferred must be valued at "fair market value". In general, the IRS defines fair market value as the price which an unrelated person with knowledge of all relevant facts (an independent buyer) is willing to pay the seller to purchase the asset. Thus, county appraisal district "Market Values" may or may not reflect the true market value of a piece of property. Reasonable discounts are allowed for transactions involving undivided interests in property or interests in property of any type that are subject to restrictions on transfer (such as interests in closely held businesses, FLPs and LLCs). Further, the sale must be structured in a commercially reasonable manner. Thus, the buyer must either pay cash equal to the fair market value of what is being purchased *or* the buyer must make a cash down payment and sign a promissory note for the balance of the purchase price (in the real world, very few people are able to obtain 100% financing for their purchases, so a 100% financed deal may not be commercially reasonable). The promissory note for the balance of the purchase price must be structured to provide for interest at the "Applicable Federal Rate" (AFR) to avoid potentially adverse gift tax *and* income tax consequences. These AFRs are published monthly and reflect market interest rates based on the term (time period) of the note.

Often, a parent who "sells" an asset to a child for a down payment and a promissory note intends to forgive the payments the child is supposed to make on the note. The risk of doing this *from the very beginning* is that the IRS could take the position that the parent never intended to sell the property to the child in the first place, but, rather, intended to make a gift to the child of the full value from

the beginning. Thus, the safest course is for the child to make the required note payments for at least the first year or two. After that, if the parent wants to forgive the note payments and if the amount forgiven is within the gift tax annual exclusion, then, arguably, there is no reportable gift with respect to the transaction.

Potential GST Transactions in 2010. In 2010, because there is no GST Tax and because the applicable gift tax rate is "only" 35% (instead of the previous 45%), many estate planners have been discussing with their wealthier clients the idea of creating and funding a very large Generation-Skipping Trust. The problem is that Congress might decide to pass a law during 2010 reinstating the GST Tax and making the law retroactive to January 1, 2010. So, even though a very large Generation-Skipping Transfer made right now will attract only a federal gift tax at 35% on the amount in excess of the transferor's remaining $1 million lifetime gift tax exemption and no GST Tax, if the GST Tax is retroactively made applicable to transfers on or after January 1, 2010, depending on the amount of the GST exemption allowed under such new law (and the amount of GST exemption previously used by the transferor), a hefty GST Tax may have to be paid. Because of this risk, most people are being very cautious about GST planning. Some planners have proposed some fairly sophisticated techniques involving the creation of an *irrevocable* lifetime QTIP Trust (a marital trust for a spouse), disclaimers and the QTIP election to fund or not fund a GST Trust. Again, this is probably more work and more risk than the average client wants to incur. So, our take is that most of the discussion of GST planning opportunities in 2010 is theoretical and not practical.

The 2010 Income Tax Basis Rules. As indicated in the Special Alert dated December 30, 2009 we sent to some of you, the previous unlimited step-up in basis for assets passing as a result of the decedent's death does not apply in 2010. Instead, a "modified carry-over basis regime" will apply per Section 1022 of the Internal Revenue Code. This means that more beneficiaries will be paying capital gains taxes when they sell inherited assets than ever before. For decedents who die in 2010, assets with a date of death value that is lower than the decedent's tax basis in the assets will experience a "step-down" in basis for income tax purposes. Further, assets with a date of death fair market value that is higher than the decedent's tax basis will either have a carry-over basis (same basis in hands of beneficiaries as decedent had) or, to the extent the Executor of the decedent's estate makes the election to allocate the Section 1022 basis step-up to those assets, will experience a step-up in basis similar to previous law (although possibly not a 100% step-up in basis). There are also a couple of technical adjustments to basis if the decedent has any unused net operating loss carryovers or unused capital loss carryovers.

Besides the $1.3 million potential basis step-up for every decedent who dies while the 2010 law is in effect, married decedents have an additional potential basis step-up of $3 million. To obtain this additional step-up in basis, the assets in question must either pass outright to the surviving spouse (or be deemed to be passing outright to the spouse) or pass to a "QTIP-able" Trust created for the benefit of the surviving spouse.

Nothing in Section 1022 indicates *how* the Executor must choose among the assets with a potential for the basis step-up. Notably, the Executor can make the allocation to both probate and non-probate assets, even though the Executor has no legal right to administer the non-probate assets. In estates having beneficiaries with competing interests (such as children from a prior marriage and a surviving spouse), this presents a huge fiduciary liability risk for the Executor. Further, for decedents dying in 2010, the Executor must file a federal tax report if the estate is valued at $1.3 million or more to make the basis step-up allocation. In the report, the Executor must provide the decedent's tax basis in each asset, something that could be very difficult for the Executor to determine (depending on the decedent's records). A very large federal tax penalty (as much as $10,000) is imposed on Executors who fail to file the return or who fail to report all of the detailed information required. Thus, an already high risk job–serving as the Executor of a decedent's estate–just got much riskier.

There are trade-offs between planning for the Section 1022 basis step-up and planning to reduce the payment of future estate taxes. For example, outright gifts to the surviving spouse qualify for the spousal basis step-up, but such gifts also "stack" those assets on top of the spouse's own assets, possibly causing the surviving spouse's estate to exceed the applicable estate tax exemption amount at death, resulting in the payment of hundreds of thousands of dollars of otherwise avoidable estate taxes. This is especially true if the law on the books remains as is–a $1 million estate tax exemption and 55% top estate tax rate for decedents who die in 2011 or thereafter.

People Who Really Should Come in for an Estate Planning Check Up Soon. In December 2009, we sent a "Special Alert" to both current and dormant clients regarding the estate tax situation in 2010 (dormant clients are people for whom we have done estate planning work in the past, but for whom *we are not currently doing any estate planning work*). Dormant clients whose estate plans were created within the last 5-8 years ("recent dormant clients") can probably "sit tight" to see what, if anything, Congress will do in 2010 regarding the estate

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tax laws. The exceptions among our recent dormant clients–i.e., those who should come in soon–would be (i) married clients who are in poor health and (ii) clients whose estate plan was divided between their children from a prior marriage and their current spouse using the estate tax exemption amount as the basis for the division.

In contrast, dormant clients whose estate plans were created in the 1980s or 1990s who have not come in for an estate planning check up within the past 5-8 years may be at *serious risk* of having an out-of-date (and possibly disastrous) estate plan. For one thing, the exemption from the estate tax was extremely low in the '80s and '90s. Back then, a lot of married couples signed "tax-planned Wills" that used a formula to create a Bypass Trust. Thus, under such an old Will, a Bypass Trust may have to be created on the first spouse's death, even if the surviving spouse and children do not want it. Also, any client with an estate plan created in the '80s or '90s who has an interest in either a qualified plan or an IRA will not have the necessary provisions in his Will or Living Trust to allow those assets to pass into trusts for beneficiaries without accelerating all the income taxes (because the final Treasury Regulations relating to these assets were not published until April 2002).

For years, we have been preaching to our dormant clients the need for "regular check ups", meaning: Come in at least once every 5 years to make sure your estate plan still works well for your loved ones. Besides the continuous changes in the federal tax laws, state law changes (such as the massive changes to Texas trust laws in 2004) affect a person's estate plan, too. Further, changes in your financial and personal situation have as much of an impact (if not more) on the suitability of your estate plan. In view of how rapidly changes of all types occur these days, Wills and trusts cannot be expected to last 15 or 20 years any more. Thus, if your estate plan was created before the turn of the century and you haven't been back for a check up within the past 5-8 years, please call to schedule a check up soon.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

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