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The Impact of Recent Tax Reform and the Need to Make Changes

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Last year's new tax laws have important consequences upon planning for most estates. This is true whether the estate plan is documented by a Will or a revocable living trust declaration. The reason is that, *if the new laws are subsequently made permanent, both the estate tax and generation-skipping transfer tax* (the "extra estate tax" called GST we pay on sizable gifts to grandchildren under certain conditions) *will be repealed*. Most estate plans for couples use a mathematical formula applied after the first spouse dies which operates to defer and minimize death taxes. The formula directs the allocation of the couple's combined estate through available applicable exclusion amounts (formerly called *unified credits*) and the "unlimited" estate tax marital deduction to establish the "*Credit Shelter Trust*" and the "*QTIP Marital Trust*" for surviving spouse and family. Permanent estate tax and GST repeal may cause these formulas to yield unintended results to the inheritance of the couple's property.

When their estate plan was drafted ten years ago, this couple expected that only $400,000 of the deceased spouse's one-half of the community property estate ($1 million) would be allocated to the credit-savings device and the balance of his or her share ($600,000) would be applied to the widow or widower. The formula provision of their trust instrument was written to "adjust" depending on the amount of the unified credit then available under the estate tax law. That's okay up to a point, perhaps. But when the applicable exclusion amount gets really big relative to the net worth of the couple, the estate plan for the surviving spouse goes awry.

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Sunset Provision

Still more difficult to manage is whether estate tax and GST repeal will really take effect. The way the new laws are written the outcome is completely dependent upon future legislation. Without future legislation, while a "phased-in reduction" in taxes over the next seven years is presently scheduled (though also subject to legislative change), repeal in 2010 will "sunset" in 2011. As the law stands, *only* for deaths occurring in 2010 will there be no estate tax or GST imposed (and here again the formula contained in most estate plans will not work properly). While President Bush wants these changes to be made permanent now, it remains to be seen whether that will be the long-term result. Capturing Republican control of both the House and Senate may serve that platform. Still, scheduled repeal will occur under a different administration. Subsequent legislation could change that result.

Life Insurance and Other Tax Savings Methods

And without estate tax or GST to worry about, other death tax savings methods (particularly the use of *irrevocable* instruments) may go by the wayside. Expensive life insurance policies may be unnecessary for death tax liquidity purposes, though such coverage may be needed to support one's family in case of an early demise of the "income-provider." Even so, term insurance coverage may be adequate for the relatively brief period policy proceeds may be useful. Accordingly, the use of complicated *irrevocable life insurance trusts* and nettlesome *Crummey withdrawal powers* (which allow parents to make annual premium gifts without federal gift tax) may be obviated. Actually, under the new tax laws the *Crummey* powers included in many existing irrevocable life insurance trusts may be ineffective after 2009.

For many, the continued reliance upon *charitable trusts* as an estate tax savings device may be unnecessary (especially those plans which employ *replacement* life insurance coverage). Also, the use of family limited liability companies (LLCs) or

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limited partnerships may play a reduced role since those devices have generally been employed to create valuation discounts of the business interests, stocks and real estate often transferred there.

Flexible Drafting Solutions

While death is a certainty, thankfully when we will die is beyond the knowledge of mere mortals. Recognize that a couple will encounter different estate tax and GST results if the death of the first spouse to die occurs *before*, *during* the tax reduction phase-in, or *after* permanent tax repeal takes effect (if at all). So, estate *planning* becomes confounded. Do we draft instruments expecting permanent repeal (and if so, what should these documents say until then)? Or do we anticipate that tax repeal will sunset (and decide to change our estate planning documents only when and if subsequent legislation makes repeal permanent)?

Suggestion: *Simply do the best you can as more is known, clearly identifying your testamentary goals in the meantime by using drafting techniques appropriate for the nature and size of your estate. Draft to insure flexibility in the administration and interpretation of your estate plan after a death. Discuss planning alternatives with your advisor.*

Remember, while planning for estate taxes is important, it is your "*non-tax*" wishes that count the most. That tenet will become ever more apparent if death taxes are permanently repealed. But the point should not be overlooked in the meantime. And for many, the phase-in of larger applicable exclusion amounts and GST exemption levels may already or soon make death tax considerations relatively unimportant (subject to some important exceptions regarding income tax basis step-up and carryover which take effect in 2011). Most clients will still want to avoid probate using revocable living trusts. This also makes sense in case a spouse (or both spouses) becomes disabled (by avoiding expensive conservatorship proceedings). And setting up continuing trusts for grandchildren with a limited portion of the couple's estate can help achieve other goals such as

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education needs over the long-term (also consider the use of so-called "*Section 529 Tuition Plans*" for this objective). To some extent, the continuing use of trusts can also achieve limited creditor protection under certain circumstances.

Revisiting the Formula

One area of most immediate concern is the formula provision described in the example. It is still a good idea to defer and minimize estate taxes through the use of such a clause, but the results should be calculated ahead of time under different scenarios. Estate tax projections can give the necessary information. And there are other options available, such as the use of "disclaimers" (where the surviving spouse decides how much of the deceased spouse's one-half of the community property should be allocated to an "equivalent" of the credit-shelter trust (a so-called disclaimer trust)), and Credit Shelter Trusts drafted to make the marital deduction available, if elected. Another method of achieving flexibility is to allow for the appointment of a special trustee (an unrelated third party) with discretion to modify the estate plan to achieve your "stated" goals if death taxes are repealed. This discretion could include modification of the formula provision.

Gifting Strategies

Unlike estate tax and GST, federal gift taxes are not scheduled for repeal in 2010. The lifetime gift tax exclusion is now $1 million. As we move towards 2010 the maximum gift tax rate will decline to the then–top individual income tax rate of 35% (this income tax rate reduction is included as well under the new tax laws). Accordingly, since estate taxes may be repealed, prudent estate planning now suggests avoiding "taxable" gifts (those exceeding available exemption amounts). The estate planning technique of transferring asset ownership to others (such as through a "grantor retained annuity trust" (acronym GRAT) or through installment sales such as to an "intentionally defective income trust" (acronym IDIT)) to exclude future appreciation from estate tax at little or no gift tax cost requires much more careful consideration than before the new tax laws were enacted.

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Generation-Skipping Transfer Taxes

The exemptions for GST will parallel those applicable to the estate tax as the phase-in period progresses. Accordingly, estate plans that automatically create GST-exempt shares for grandchildren (a continuing trust usually carved out of a child's outright share) will grow. Many revocable living trust instruments are drafted in a manner keyed to use the amount of available GST exemption. So, in certain instances it may be appropriate to limit the size of the allocation. Concomitantly, once GST is repealed, no portion of the child's share would be set aside for grandchildren under such a provision. This result may also be unintended. Modifying trust instruments now for that event may deserve attention.

Example:

Say a married couple has a net community property estate worth $2 million. Everything is held in a typical revocable living trust created ten years ago. If one spouse dies this year (2002) or next, that spouse's one-half share would be first "allocated" to the unified credit-savings device (commonly to the Credit Shelter Trust benefiting spouse and children, or set aside in a separate trust for children, depending on how the instrument is drafted) with the balance (if any) allocated to a marital share (or QTIP trust) for the surviving spouse. At this level of estate value, the applicable exclusion amount alone is not enough to eliminate death taxes on the first death. No portion of the deceased spouse's one-half community property estate will be allocated to the marital share. In 2004, the same result will obtain for community property estates worth up to $3 million, $4 million in 2006 and $7 million in 2009.

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