Estate & Succession Planning Corner

The Estate Planning Times, They Are A-Changin'

By Louis S. Harrison

The American Taxpayer Relief Act of 2012 (the "2012 Act"), a relatively quiet tax bill with few changes, has had major impacts on our practice as estate planners.

Two changes in the 2012 Act—an increase in the estate and gift tax exemption to what is now an indexed $5.45 million amount, and the advent of portability—have affected most tax aspects of the planner's practice, directly or indirectly, including:

1. type of estate tax plans and how to draft for them,
2. types of planning done for clients,
3. advocacy of changing title between spouses,
4. IRS reviews,
5. development of new practice areas,
6. commoditization,
7. malpractice,
8. domicile planning,
9. life insurance,
10. basis planning,
11. unwinding of family limited partnerships,
12. charitable planning (specifically, charitable lead trusts), and
13. grantor retained annuity trusts (GRATs).

a. Types of Estate Tax Plans and How to Draft for Them

The increase in the exemption to what is now $5.45 million means that the federal exemption is, in certain states, higher than the state exemption. This requires the introduction of a new trust in estate plans, a federally exempt trust that may be state qualified terminable interest property (QTIP), if allowed. For example, in Illinois, the state exemption is $4.0 million. This means an estate plan, for say a couple with $9 million in the first spouse to pass away, could have the following trusts: a $4.0 million state and federal exemption trust, a $1.45 million federal exemption trust that qualifies for state QTIP and the balance ($3.55 million) outright or in a federal QTIP trust for surviving spouse.

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Further, with the advent of portability, no longer is it absolutely certain that a credit shelter trust should be created. Therefore, the estate plan needs to be drafted to potentially accommodate the credit shelter trust being included in the surviving spouse's estate on passing, allowing portability if the decision is then made at the first spouse's passing to elect portability.

b. Types of Planning Done for Clients

Because of the multiple trusts that must be created, per the discussion in Section a. above, the drafting has become complicated. Perhaps Treasury, in new regulations or pronouncements, will clarify that QTIP elections can be made for portability purposes, even if no tax deferral is required, and then a single-fund QTIP trust may be the drafting of choice.[1]

Assuming Treasury allows for this result, the single-fund QTIP allows a practitioner to achieve the following for the client:

1. For the portability decision to be decided at the surviving spouse's passing. Estates may want to include 100 percent of the property in the surviving spouse's estate to achieve a step-up in income tax basis. The goal will be either to make a partial QTIP election to create a credit shelter trust out of the nonelected portion (the $5.45 million estate tax exclusion amount) or a full QTIP election to put all the property in the surviving spouse's estate for basis step-up reasons.
2. For state inheritance tax to be avoidable at the first spouse's passing if that state has a QTIP marital deduction, even if that state has a credit that is decoupled from the federal credit.
3. Ease in drafting.
4. Ease in client understanding.
5. Ease in administration until multiple trusts are created (post-mortem).

c. Advocacy of Changing Title Between Spouses

Since 1982, planners have had to discuss with spouses the need to shift assets to the nonpropertied spouse to allow for that spouse to have assets to fund the credit shelter trust, in the event that spouse predeceased the other. With portability, that shifting of assets is no longer necessitated to protect use of the exemption. Because of concerns over how a shift in title may affect property rights on divorce, this area of discussion becomes more difficult. Perhaps, asset transfers to allow credit shelter funding will be ignored by planners.

d. IRS Reviews

As planners, we used to assume that the IRS would not review many gift tax returns and that often estate tax returns would, likewise, go unreviewed. For example, there were only so many agents, and only so much time to review the number of returns that were being filed. Anecdotally, based on statistics presented at recent conferences, that nonreview (one percent of gift tax returns, for example) is continuing. But mathematically, that result truly cannot be occurring. With the exemption now protecting married couples with assets totaling less than $10.9 million, the number of estate tax returns filed has likely decreased by 50 to 80 percent. Therefore, we have to expect that more returns will be audited on a percentage basis. And, based on the experiences reported by practitioners, the results support that conclusion: almost all estate tax returns are being reviewed in more detail, many resulting in some level of audit, and a greater number of gift tax returns are being reviewed. The level of practitioner effort that goes into these returns, which always should have been substantial, should continue. In addition, the practitioner should recognize that returns have a great chance of being reviewed.

e. Malpractice

As a result of Section d., the malpractice risk is also increasing. This occurs in multiple ways. First, planning that was done unsuccessfully before may not have been reviewed and, therefore, would have been successful in effect. That same planning may now be challenged and defeated. Second, even planning that is done right, but nevertheless challenged by the IRS, is often subject to client second-guessing. Recent lawsuits against planners who have had their estate tax planning challenged by the IRS support that conclusion. Third, with the increased exemption and portability, clients who had estate tax planning in the 1990s and early 2000s may no longer need it but could avail themselves of increased basis step-ups if there is full inclusion. Have all estate plans been reviewed to shift from an estate tax exclusion trust to a basis step-up trust?

f. Development of New Practice Areas

Also emanating from the increase in the exemption amount, there are fewer reasons to draft estate tax plans.

Anywhere from 50 to 80 percent of estate planners' prior tax planning estate plans have now been rendered obsolete. Therefore, less estate tax drafting is occurring. Further, with the complication associated with advanced estate tax planning, and the possibility of estate tax repeal, fewer practitioners are well versed in that advanced level of planning. Therefore, estate planners have been shifting to other areas of practice, to replace the lost work on the estate tax planning front. In future columns, we will discuss these areas of practice expansion.

g. Commoditization

With less work on the estate tax planning side in estate planning documents, the drafting of documents has continued to evolve as a commodity. Clients will often perceive the drafting process as one in which the least amount of effort and time and cost should be spent. Since a client may perceive no estate tax advantages to their documents, they may have less of a desire to pay for drafting. Moreover, replication of nontax forms becomes easier for third parties, lawyers and nonlawyers (Legal Zoom, for example) who may want to provide "forms at a cost."

As an editorial, the drafting is still important and valuable to a client. Carefully constructed creditor protection trusts, spousal protection trusts, incentive trusts, trustee provisions and overall drafting remain highly valuable to clients and worthy of practitioner effort.

h. Domicile Planning

The shift in focus to income taxes, and the disparity in states as to inheritance taxes, has caused a diaspora in domicile among our clients. Retired clients are often willing to shift domicile to a state with no income taxes or one with no inheritance tax. For example, it has been reported that more millionaires left Illinois last year as their domicile than any other location other than Paris.

i. Life Insurance

For many plans, life insurance was used, or advocated for use, as a replacement for the estate tax dollars. Whether or not the math worked for this result, nevertheless, the concept was often accepted by clients. *E.g.,* "You have an estate tax of $5 million, but you can purchase an insurance policy with a face value for $5 million to replace that tax." With the increase in the exemption amount to what is currently about $11 million for a married couple, a substantial majority of these prior plans/insurance policies are no longer needed.

Interestingly, for just about every client, there is a reason to consider insurance in the plan. For example, the high net worth 100-percent liquid client with $20 million may still legitimately consider insurance as an alternative investment, in his or her portfolio, to provide a guaranteed internal rate of return tied to the death benefit.

j. Basis Planning

Income tax rates keep going up, new excise type taxes are introduced (for example, the Obamacare tax), state income tax rates are going up and the federal estate tax rate is going down. The value of federal estate tax planning is decreasing, while the value of obtaining an income tax step-up is increasing. For example, for a client with say $12 million, that last $1 million is subject to federal estate tax at 40 percent. But that same $1 million could obtain a basis step-up of 30.8 percent (20 percent cap gains, plus 3.8 percent Obamacare and plus seven percent state tax), thereby yielding a differential of only a little over nine percent.

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The critical part of this equation is that when there is no federal estate tax, the planning must focus on obtaining a step-up in basis. Therefore, a federal exemption trust set up at the first spouse's passing, that is in fact unneeded, will prevent a second basis step-up at the surviving spouse's passing.

With portability, this has to be examined in more detail, and the possibility of a second basis step-up planned for and, if possible, preserved.

k. Unwinding of Family Limited Partnerships

The discussion in Section j. above becomes especially critical for older family limited partnerships. A discount of 30 percent in family limited partnership assets for federal estate tax purposes will reduce the estate tax by 30 percent.

It will also result in either a reduction of basis (for bonds, for example, which usually have a basis equal to fair market value) for income tax purposes of 30 percent or a loss in basis step-up (for appreciated assets with a low basis at death) of 30 percent. If there is no estate tax, partnership assets nevertheless are still supposed to be discounted by their illiquidity and lack of control, 30 percent in this discussion (could be more, could be less, depending on fact patterns). Hence, basis step-up could be lost, or basis step-down could occur, for no reason. Therefore, practitioners must review and unwind partnerships if the nonestate tax reasons are no longer there, and if there is no estate tax reason to continue them.

l. Charitable Planning (Specifically, Charitable Lead Trusts)

With the increase in the exemption, many clients feel that their children have enough assets just based on the tax-free amount. Clients may want to adopt estate plans that leave amounts in excess of the estate tax-free amount to charities, *via* charitable foundations, donor advised funds or other strategies. Though this should have been the same result as before, the quantification of the exemption at greater than $10 million has now focused clients on that amount, and how it feels to pass that amount to their children. Clients tend to be more focused on charitable planning these days. As part of the charitable planning, a charitable lead trust, the charitable cousin of the GRAT, is a strategy that should take on more relevance (especially with the applicable federal rate being so low these days).

m. GRATs

Clients with estate tax planning now have to focus on advanced strategies to reduce their estate tax. From a "tried and true" perspective, statutorily authorized by section 2702 of the Code, and effective if structured correctly, the GRAT is the planner's go to strategy of choice. Although a "sale to a grantor trust" is a bit more flexible and easier to use, the sale has been under attack in recent years by the IRS, and its viability not as certain as that of the GRAT.

ENDNOTES

1 Rev. Proc. 2001-38, 2001-1 CB 1335 could imply that QTIP status is not "electable," if there is already no estate tax. A recent letter ruling (LTR) confirmed this possibility. That is, if a client's gross estate were $5 million, he made no lifetime taxable gifts and his surviving spouse wanted to elect QTIP status, the LTR could be interpreted to prevent that election, because even without the election of QTIP status, there would be no estate tax. The estate-planning community has advocated for clarification that QTIP elections in estate tax returns required only to elect portability are valid. I would hope that Treasury understands the practical reasons to practitioners to allow for this flexibility.