The 2010 End -of -Year Estate Tax Law: Certainty (??!) At Last

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1. What has come before...Background to the law.

Since the early years of this millennium, estate planners have looked at the "chart" showing the ever increasing estate tax limits, wondering how Congress would "fix" the bizarre results that scheduled for 2010 and 2011. According to that prior law, in 2009 there was a $3.5 million estate tax exemption available for every individual, but, in 2010, a complete repeal of the estate tax kicked in, but in 2011 (due to some technical requirements), that repeal and all of the increases were erased, and everyone was reduced back to a $1,000,000 estate tax exemption. Conventional wisdom among professionals was that neither the 2010 nor 2011 provisions would come into play, and that before then, Congress would do the "reasonable" thing and agree to a permanently workable exemption, such as $3,500,000 or even $5,000,000. Lo and behold, Congress did not do the reasonable thing, and as estate planners looked on, 2010 came to pass with no estate tax whatsoever, and at least a few billionaires died during this year completely exempt from the estate tax.

However, for much of 2010, again, conventional wisdom said that somehow, before 2011, Congress would do something before the estate tax limit dropped all the way back to $1,000,000, and a great many regular folk, when considering retirement plans, homes, and insurance, would be brought back into the estate tax regime. As 2011 wended down to its last grains of sand, inside information and practical considerations left it looking like we were plummeting back to that level. However, again, Congress zigged when we were expecting a zag, and the estate tax provisions were patched into the extension of the Bush tax cuts, and, surprisingly, a resolution was not only reached, but it was more generous than might have been guessed.

But, above all, it added more confusion to the planning process, and, as explained in more detail below, it should be carefully noted that the relevant title in the bill is, "TEMPORARY Estate Tax Relief."

2. **The Estate Tax Exemption**. The most important change in the new estate tax law, is that the estate tax exemption for 2011 and 2012 is up to $5,000,000. That means, no matter who someone leaves their assets to, if they all add up to less than $5,000,000 at the time of death, there is no estate tax at all. This is also now indexed for inflation...but since there will be only one "new" year, 2012, for which this will be applicable, it may not be of great concern. Just enough to make our explanations that much more confusing.

3. **The Estate Tax Rate**-The highest estate tax rate used to be 55%, it was down to 45% in 2009, but under the new law, the highest estate tax rate will be reduced to 35%. This is where the wealthiest families will most significantly reduce their potential tax liability, the government will lose the most money.

4. **Gift Tax Exemption**. A very significant change for estate planners is that the gift tax exemption is increased to the same $5,000,000 as the estate tax exemption. This is a drastic variation from convention, because even in 2009, when the estate tax exemption was $3.5 million, and 2010, when there was no estate tax at all, the gift tax exemption was still only $1,000,000. Therefore, for wealthy clients looking to make really large gifts while they were alive, there was a limit before they had to start paying gift tax...a pretty big impediment. But suddenly, with the ability to make up to $5,000,000 in taxable gifts as part of the planning process, a great deal of opportunities will open up.

   Two notes about aspects of the gift tax exemption that are sometimes confusing. The first is that this gift tax exemption used also counts against the estate tax exemption. So you cannot give away $5,000,000 tax free during lifetime, and leave another $5,000,000 tax free at death. Roughly speaking, any amount of this $5,000,000 you use up on taxable gifts while you are alive counts against your exemption at death.

   The second is the interrelation with the $13,000 annual exclusion, which used to be $10,000 but is now indexed for inflation. That is the amount any one person can give to any other person during a year, that does not even count towards their gift tax exemption. So, once you exceed that amount to one person in one year, you generally use up part of that big $5,000,000 gift tax exemption. For people with less than the gift tax exemption, it means that they can really give away as much as they like, over and above the $13,000,

without any real tax consequences. (Though they may be required to file a gift tax return documenting the excess gifts.)

5. **Generation Skipping Transfer Tax Exemption**-Less of a change than the gift tax, the Federal Generation Skipping Transfer Tax Exemption is also raised up to the estate tax exemption of $5,000,000. This is the amount that can be applied to transfers to grandchildren, or to continuing trusts, that will not be subject to the additional GST Tax when it passes to grandchildren or remote descendants. (Practically speaking, it is the limit to how much people can put into trust for their family that will never again be subject to estate tax, with proper planning.) Because this law will apply to 2010 estates, unless opted out, the return to a normal application of the GST allocation rules will make planning much more straightforward.

6. **Portability**-This concept, which might also be described as, "Let's not make couples set up Credit Shelter Trusts" is intended to give the survivor of a husband and wife to carry forward any unused estate tax exemption from the first spouse's death. This is the basic concept behind the "A-B" arrangement that creates the irrevocable Trust B/Family Trust/Credit Shelter/Bypass Trust[1] is a bread-and-butter estate planning technique.

   For example, if there is a $5,000,000 estate tax exemption, and a husband and wife have $10,000,000, under all our prior law, the planning would be to have the husband and wife establish an A-B Trust, so that when husband died, his $5,000,000 share would go into a Trust B/Family Trust/Credit Shelter/Bypass Trust for wife, and wife would have her own assets in the Trust A/Survivor's Trust. Assuming no change in value, when the wife died she only had $5,000,000 subject to tax, the amount of the exemption, the Trust B/Family Trust/Credit Shelter/Bypass Trust was not taxed, and there was no estate tax at all. Until the brand new law, if the husband and wife hadn't set up that arrangement, and left all the money outright to the survivor, when wife died, she would have owned $10,000,000 subject to estate tax, much more than the exemption, and there would be a significant tax of about $1,750,000!

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[1]Because of the variety of naming conventions for this irrevocable trust created by the decedent, I'm using this unwieldy but somewhat complete name throughout.

Now, under the new "portability" provisions in the estate tax law, even without the trust arrangement, it may be possible for the surviving wife to use her husband's unused exemption. However, it requires that the first spouse's estate file a timely estate tax return making an election that this exemption can be used by the survivor.

7. **<u>Return of the Step-up in Cost Basis</u>**-The new law brings back one of the tax benefits to dying, a full step up in the income tax cost basis of most assets, to the new date of death value, so that the estate or the beneficiaries could sell highly appreciated assets without paying capital gains income tax. Under the short estate tax repeal of 2010, this step-up did not uniformly apply, though it did apply to the first $1.3 million of appreciation in an estate, with an additional $3,000,000 "step-up" available for property that went to a spouse. In other words, for anyone worth less than $1.3 million at death, they got a step-up in basis as before, but for larger estates old cost basis had to be determined and they had to figure out how to apply their limited amount of "step-up."

8. **<u>What Happens for 2010 Estates?</u>** The law also clarifies (or complicates) what happens for a decedent who died in 2010. The default application is that the "new" law, a $5,000,000 estate tax exemption, with a full-step up in cost basis. So, for an individual who died with $3,000,000 in highly appreciated assets in 2010, the new law will apply, there will still be no estate tax, but all those assets will get a step-up in the cost basis.

   However, for the Steinbrenners' of the world, an estate can still elect to have the ORIGINAL 2010, no-estate-tax, no-step-up-in-cost-basis apply. This must be an affirmative election. Therefore, for estates UNDER $5,000,000, there is little likely reason to opt out of the new law, as it offers the full step-up in cost basis (or step-down) and the full allocation of the GST exemption. For estates over $5,000,000, without offsetting marital or charitable deductions, it may be advantageous to opt back in to full estate tax repeal. HOWEVER, looking at the overall capital gains/estate tax issues to determine the best result would be necessary.

   For those in that above-$5,000,000 mark, the law requires this election be made "at such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide." The law also provides that, for someone dying in 2010 (before the new law

went into effect) the due date for the estate tax return and any elections is nine months from the date of the new law.

9. **2012**. Ah, here we get a return to form. After all of this, this law will again expire on December 31, 2012, meaning that, if nothing is done (again!) prior to that time, we will again revert back to the old-old estate tax law, with a $1,000,000 estate tax exemption. At this point, however, I have exhausted my ability to speculate what the likely action will be prior to that time, who will be in power, which way the winds of the economy have swung, and which congresspersons and senators wish to get which deal done. However, for context on this seemingly endless back and forth, and sustained tone of uncertainty, I highly recommend you track down the article "Shakedown at Gucci Gulch", an article by Professors Edward J. McCaffery and Linda R.Cohen, about the incentive for congress to keep an ongoing estate tax debate alive, because it is uniquely well suited to keep milking lobbyists and supporters on both sides of the issue, and that is in the individual legislator's self-interest over some kind of permanent solution.

So....WHAT DO WE DO????

10. **Meet your Estate Planning Attorney- Nuttier than Ever**. Some of our estate planning situations will remain the same as they were before. A husband and wife with $200,000 in assets will need no estate tax planning, a husband and wife with $20,000,000 will still need estate tax planning. But as you deal with clients in between, a couple with $3,000,000, it becomes increasingly convoluted to explain to clients their options, the costs and potential benefits, so they can make their decisions. That, after all, is the role of the estate planning attorney in general.

    Back in say, 1999, the conversation used to go something like this:

    "You have $3,000,000 in assets. Assuming your assets don't really change much, if you do an A-B Trust, it will likely save you about $500,000 in estate tax when the survivor dies."

Now, it's something like,

"You have $3,000,000 in assets. You can do an A-B Trust. If you die in 2011 or 2012, it won't really save you any money. If you die in 2013 or beyond, and they haven't change the law, it may save you $500,000. If you die in 2013 and beyond, but they have changed the law after that, it may save you some money if the exemption's less than $3,000,000 but nothing if the exemption's more than that. However, you may not need to do this to save money if you die in 2013 or beyond, and they haven't changed the estate tax exemption, but in the year of both death's they still have this portability option in place.

However, there are some other good reasons you might want to do this A-B Trust thing, even if it doesn't save you taxes..

What would you like to do?"

Yes, Congress is making sure we don't have to say things like, "*Intentionally Defective*" and "*This Trust has Crummey Powers*!" to make our clients look at us funny and question whether we need a guardian.

11. **<u>To B or Not to B</u>**- Based on the above, it can be harder question whether a married couple need or want the A-B Trust arrangement. Of course, none of this deals with the other planning issues for a trust, such as avoiding probate and providing management during incapacity, or the benefits of other forms of continuing trust like Lifetime Protection Trusts/Generation Skipping Trusts or Special Needs Trust. Solely the issues of the "A-B" option.[2]

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[2]Perhaps it's a sign of sickness, but one thing as an attorney I find helpful is to imagine a conversation with people who are unhappy about the plan we put in place. For instance, a surviving spouse with what is apparently an unnecessary Trust B to fund might say, "*What, you mean I need to create a separate account, and file a 1041 each year. Why did you do this to me!*?" Now, instead imagine children when a surviving spouse died who end up paying any significant amount of estate tax saying, "*Why didn't you set up an A-B Trust for my parents, that would have saved $400,000? Wasn't any possibility of that well worth any minor potential administrative work if it wasn't necessary*?"

Below I discuss the added issues of this question when the couple already has one in place.

A. **Disadvantages**. What are the disadvantages of having a Trust B if I don't need one? The downsides of having a Trust B, especially if it is appropriately drafted to the clients' needs and wishes, are very slight indeed.

i. The administrative work necessary for the Trust B would involve creating that separate trust when the first spouse dies, calculating how much should be in it, and transferring assets into Trust A and Trust B. It would also require maintenance of that separate ownership and/or accounts, and a 1041 income tax return each year for the trust.

ii. The Trustee does have a legal duty to keep the beneficiaries informed. However, not only is this a custom more (frequently) honored in the breach than the observance, but, if the survivor has a power of appointment which can remove any of the beneficiaries, he or she has the ultimate power to remove someone who might be troublesome in exercising those rights. In a contentious family, if desired, the survivor can have the power to knock those kids out from causing trouble, and in a harmonious family, they can all agree to ignore it.

iii. It should be noted that an IMPROPERLY drafted Trust B can cause great problems. If the Trust requires a Co-Trustee, that can incredibly cramp the survivor's style, and a lack of power of appointment may leave them subject to harassment from contentious beneficiaries, or unable to make positive changes for children even in a harmonious family. Note that some individuals may want the survivor to have these restrictions and checks and balances over the Trust, but if a couple who trusts each other utterly ends up with the survivor bound by this type of Trust B/Family Trust/Credit Shelter/Bypass Trust , the results can be disastrous, and he or she will be pretty upset with that attorney.

B. **Advantages and Reasons to Have a Trust B**. The reasons a couple might choose to still set up the Trust B arrangement are much more plentiful and substantial:

i. **Estate Tax Uncertainty**. While a larger exemption may seem "likely" to continue after 2013, and it's possible that at some point (although, maybe not, refer to that "Gucci Gulch" article) the law might be at least more stable and long term than it is now, we just don't know what's going to happen. This current generous estate tax limit is only applicable for two more years, and the odds are most clients you prepare a trust like this for will not die within those two years. While letting it expire and drop back to $1,000,000 seems unrealistic, that is what will happen without future action, and at this point, I can simply fail to say with any accuracy what Congress will or will not do. Given that the first spouse in many plans will most frequently survive for at least 5, 10, or 20 years, guessing what that law will be impossible, and this remains a reasonably conservative approach to incur a slight administrative burden to prevent the possibility of hundreds of thousands of dollars in estate tax that could have been avoided.

ii. **No Reliance on Portability**- While the "portability" concept may, in the simplest situation, reduce the absolute need for the A-B Trust arrangement, at best it's a poor substitute. First, see point (i) on the uncertainty of the estate tax, and portability could of course be one feature wiped out as the law swings back and forth. Second, even if we could rely with certainty on that law, how it will effectively operate has yet to be determined with any degree of experience. Third, the ability to leverage the tax exempt Trust B/Family Trust/Credit Shelter/Bypass Trust versus the taxable Survivor's Trust over any period of time would greatly increase the estate tax savings over the portability option.

a. To give an example, let's say a couple has $12,000,000 in community property assets when the first spouse dies. If the couple has an A-B Trust, they allocate $7,000,000 to the

Survivor's Trust, and $5,000,000, the decedent's share up to the estate tax exemption, into the Trust B/Family Trust/Credit Shelter/Bypass Trust . Over the survivor's lifetime, the survivor lets the Trust B/Family Trust/Credit Shelter/Bypass Trust invest in growth oriented assets and takes minimal distributions. The survivor spends essentially all her money out of the Survivor's Trust. By the time she dies, the Trust B/Family Trust/Credit Shelter/Bypass Trust has increased to $7,000,000, and the Survivor's Trust has decreased to $6,000,000. Estate tax is assessed on the Survivor's Trust at $6,000,000, incurring roughly $350,000 in estate tax.

b. By contrast, if this same couple, with additional investments, did not set up an A-B Trust, and relied on portability, assuming the same net appreciation and spending, the survivor would have the full $13,000,000 included in her estate. She would be able to presumably use the first spouse's unused $5,000,000 exemption, and her own $5,000,000, and shelter the first $10,000,000. However, that leaves $3,000,000 subject to estate tax, resulting in an estate tax of $1,050,000. Therefore, the lack of ability to leverage the first spouse's estate tax exemption increased the total tax significantly.

iii. **Asset Protection**. Any Trust B/Family Trust/Credit Shelter/Bypass Trust established for the survivor should be a third party trust under Arizona law, and therefore, with appropriately drafted spendthrift provisions protected from the creditors of the survivor. Like many legal issues, this may not mean much to the survivor, unless and until he or she is sued or subject to any potential liability, in which case the protective nature of this arrangement is incredibly beneficial. If either party is setting up the document at a time when he or she is a professional subject to potential liability (like a physician) or in a business with debt or liability components, this will seem even more important. Keep in mind, this is a protection you can never achieve after the fact, if this isn't set up for the

survivor by the deceased spouse, the survivor can never even come close to establishing this trust, with his or her own money (if they receive their inheritance from the first spouse outright), that will be protected from creditors.

While this arrangement will normally not exempt the trust for the survivor for consideration for ALTCS/Medicaid planning purposes, our forms typically include an automatic provision allowing a Trustee (which would be someone else in the event of the surviving spouse's incapacity) the discretion to trigger all trust assets into a Special Needs Trust. While this has some problems with it passing muster with AHCCCS (including the fact it is not a "testamentary trust" as specifically required), well, it's a lot closer than you can ever get if there is no irrevocable trust set up when the first spouse dies.

iv. **Family Protection**. While the raison d'etre for the A-B has almost always been the tax savings, they also serve the purpose of protecting the deceased spouse's assets for his or family. For instance, in your second marriage situation, the couple may set up an A-B Trust, but with provisions that when the survivor dies the Trust B/Family Trust/Credit Shelter/Bypass Trust will pass to the decedent's children only. It's not a perfect solution (but there is none) to deal with the tension sometimes inherent in those situations, and this may be the best tool available. Of course, such arrangements have to be drafted even more carefully, based on what both spouses agree (or, as each agree, if they have separate trusts to establish a Trust B/Family Trust/Credit Shelter/Bypass Trust at death) is the appropriate balance of powers and flexibility. But even in the same-marriage-same-kids simple situation, a couple may take some comfort knowing that what's left of their estate will eventually go on only to their kids. Many times this is not the result of distrusting their spouse, but of their situation, and if they fear that if they die first their widow or widower in the throes of dementia will be wooed ro defrauded by some sweet young thing with an eye for money, this provides them a nice extra level of security.

C. **The Disclaimer Option**- A tool that became increasingly popular over the last few years of this uncertainty is the "Disclaimer Trust", a more flexible combination of the Trust B/Family Trust/Credit Shelter/Bypass Trust , and the "I Love You", everything outright to the surviving spouse (or, more typically, everything in the continuing revocable trust for the surviving spouse.) Like many techniques, we all have our biases, and I must admit I am not a big fan of this one.

i. The basics are that, the Trust would say, "When the first spouse dies, the decedent's share of all the trust assets are held in this continued trust, with the survivor's share of all the trust assets, in a continued revocable trust, for the survivor to do anything he or she wishes, including putting it all on number 6 at Vegas or gifting it to that striking cabana man/woman. HOWEVER, if the survivor elects to disclaim any of the decedent's share, it will then be held in Trust B/Family Trust/Credit Shelter/Bypass Trust for the survivor instead."

ii. Therefore, when the first spouse dies, he or she can decide whether they think all this administration work of funding the Disclaimer Trust is worth it, or not, based on whether it seems likely it will save any estate tax. If they decide it's not worth it, they do nothing. If they decide it is worth it, they can set it up and they have their Trust B/Family Trust/Credit Shelter/Bypass Trust under the terms of the document.

iii. The reasons I don't like this particular arrangement are the following:

a. The time of the first spouse's death is still a time of uncertainty. While it is possible the survivor can feel there is a much clearer picture of life expectancy, estate tax law, and assets when the first spouse dies, they really don't know, and it is not until the survivor dies when we really know whether the Trust B/Family Trust/Credit Shelter/Bypass Trust will save any money. So to some extent, there may not truly be a great deal more knowledge at the first death, then the time the documents were drafted.

b. The disclaimer, under the technical requirements of the IRC, must be made properly within nine months of the date of death. While not an unreasonable deadline, it remains too easy for time to lapse when something like that isn't done, and then it is too late. This is in interesting contrast to a mandatory A-B division, because there's really no absolute deadline for that division to take place, and while it's not great planning, it can be done, if necessary, years after the fact.

c. ***Most important, the technical requirements for the disclaimer prohibit the survivor from having a power of appointment over the trust.*** As discussed below, this is a critical tool to give adequate flexibility to the Trust B/Family Trust/Credit Shelter/Bypass Trust . So, while there is flexibility for 9 months after death, after that time, if the Trust B/Family Trust/Credit Shelter/Bypass Trust is created through disclaimer, the survivor has no more flexibility to change the ultimate disposition of the Trust B/Family Trust/Credit Shelter/Bypass Trust. I believe strongly that the latter flexibility is ultimately more important.

d. To use a sports analogy, coaches hate changes in rules that give them more choices, like NFL coaches being able to challenge plays, because it gives them more difficult decisions for which they can be criticized. A disclaimer trust seems somewhat like that, as it creates a short period where the survivor is forced to make a difficult decision about complex issues, that will effect the survivor during his or her lifetime, and their children as well.

e. However, if a Disclaimer Trust is ultimately chosen by the client, strongly consider making sure that Trust has a Trust Protector, an independent party the clients trust who could make minor changes among the beneficiaries. This will not give the survivor the direct power, but it can be much better than nothing, and provide some mechanism for changing the trust if circumstances change, the type

of changes that we would want the survivor to otherwise have the power to make under a power of appointment.

12. **<u>The Have's and the Have Not's</u>**- No, not the wealthy versus the not-so-wealthy, but those who have existing Trust arrangements with an A-B type trust division, versus those that come in with no estate planning who are starting from scratch.

The practical distinction between these situations is the extra costs and time involved to change the existing plan. The clients who already have an A-B Trust set up with appropriate flexibility, etc. which is at least arguably not necessary under this new law (although, as discussed above, that may not be the case), may not see it worth while to pay the attorney again to dismantle and reform the existing plan. On the other hand, those that come in anew who are on the fence may decide for the time being they will opt for a slightly simpler and less expensive plan.

The critical issue for those that have an existing trust is to ensure that the terms of their current Trust B/Family Trust/Credit Shelter/Bypass Trust are appropriate. There is an immense difference between a Trust B/Family Trust/Credit Shelter/Bypass Trust with inappropriate provisions, and a well-fitted A-B Trust. I think we all know that the major differences in trust provisions under different agreements are more frequently a result of the particular attorneys' preferences and forms, than they are the clients' specific wishes. Typically, one of the biggest issues is the appropriate amount of flexibility. Making sure the surviving spouse has a power to appoint the Trust B/Family Trust/Credit Shelter/Bypass Trust is critical.

Too many times I've had a survivor come into my office having just lost her husband of 50 years, with whom they had 3 trusted children who are all grown, and we discuss advantageous changes to their children's shares, to discover the Trust B/Family Trust/Credit Shelter/Bypass Trust is drafted with no power of appointment whatsoever, and that the survivor cannot enact any of these beneficial changes, at least without resorting to family agreement, court action, or decanting. Obviously, there was no good reason to not give the survivor the power to make changes, at least among the children.

However, it can swing the other way. When you see a second marriage, with separate children, and the surviving spouse's power of appointment over the Trust B/Family Trust/Credit Shelter/Bypass Trust is drafted so that the survivor can disinherit all the decedent's own children, that may not be what those clients really wish.

As indicated above, this type of family protection is a reason wholly unrelated to taxes to keep or create the irrevocable trust. But, if the decision is whether to form the A-B arrangement purely for tax reasons, or keep things simple and give everything to the spouse, then by giving the spouse the broadest possible power of appointment you give him or her the most flexibility.

I think anyone who's reviewed a great deal of trusts from different attorneys and different states knows that these options are all over the place, and you'll never really guess what the trust includes without reviewing it.

Here is a sample of questions you can ask when reviewing an existing Trust Agreement:

A. Does it give the survivor enough control? I.e., can the survivor act as the only Trustee, have reasonable latitude to make decisions about distributions, AND DO THEY HAVE A POWER OF APPOINTMENT?

B. In a circumstance where protecting the children's inheritance is also an issue, does the survivor have too much control in the above areas? There's no wrong or right, only what both clients understand and choose to do.

C. Does the Trust B/Family Trust/Credit Shelter/Bypass Trust meet all the technical requirements to stay out of the survivor's estate? I.e., are the standards of distribution limited to health, maintenance, support, education, and DO NOT include words like comfort, happiness, or best interest? Is any power of appointment "limited", so it can't be exercised in favor of the survivor's estate and creditors? This limitation is necessary to make sure it doesn't get taxed in the survivor's estate.

D. Does the Trust have the proper order of Trustees?

E. While a bit unrelated to this particular discussion, are there continuing lifetime trusts for the children after the survivor's death? Very flexible, self-trusteed arrangements for children can give them all the power they need to use and spend their inheritance, but can offer incredible benefits in protection from spouses and creditors, and have become a highly, highly recommended part of any estate plan, whether or not the clients have an actual "A-B" trust arrangement at the first death.