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A FIRST LOOK AT THE NEW ESTATE TAX LAW –
WHAT AM I TELLING MY CLIENTS?

So, after nine years of waiting for Congress to give us a definitive answer to the question of what to tell our clients about how estate taxes will affect them, what did we get? We got a two year band-aid that leaves us with even more questions unanswered.

Since it is my job to provide the best advice and counsel I can to my clients, I have spent the past month studying the new law and determining how best to approach the new changes in the law, while at the same time dealing with the future uncertainty presented by the temporary nature of the new legislation. After reviewing the law and many articles by various commentators, and attending the annual Heckerling Institute on Estate Planning in order to learn what the country's leading experts are thinking, I have developed my blueprint for moving forward, so I thought I would share it with you in the hope that it may assist you in advising your own clients.

No doubt you have read (or had the chance to read) technical explanations of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010"). This article will not include a detailed review of the entire Act. Rather, I will only discuss the main elements of the Act that affect estate planning and how I intend to advise clients with regard to their estate planning documents.

THE FOUR KEY ELEMENTS OF THE NEW ESTATE TAX LAW

1. ***Estate Tax Exemption increased to \$5 million***

The most notable element of TRA 2010 is the increase in the estate tax exemption amount to \$5 million. As you recall, under the previous law (the 2001 Act known as EGTRRA) the estate tax exemption had increased from \$1 million to \$3.5 million, where it stood in 2010. Under the "sunset" provisions, it would have reverted to \$1 million this year. So for at least the next two years, only estates above \$5 million will be subject to federal estate taxes. And since we've retained the basic structure of the estate tax, including the unlimited marital deduction, a married couple with \$10 million or less can completely avoid the federal estate tax.

2. *“Portability – The Deceased Spousal Unused Exclusion Amount (“DSUEA”)*

Another key provision in the new law is the concept of what is commonly referred to as “portability.” Portability is a legislative answer to the common complaint that the estate tax laws require married couples to engage in complicated planning that they would otherwise prefer to avoid. Under the previous estate tax structure, even though each individual is entitled to his or her own estate tax exemption, that exemption had to be used at the time of the death of the first spouse. Inasmuch as many people fail to properly plan their estate, married couples often were unable to take advantage of both exemptions because their wills did not have the provisions required to establish “credit shelter” trusts and/or because their assets were not titled in such a way as to utilize both exemptions. Critics of the estate tax often complained that it was unfair to require citizens to engage in complicated estate planning in order to take advantage of the law’s provisions. This criticism gave rise to the so-called “portability” provisions.

Note that the new law does not actually use the term “portability.” Rather, it refers to something known as DSUEA – the Deceased Spousal Unused Exclusion Amount. The word “portability” refers to the fact that, under the new law, if one spouse dies and does not use any or all of his or her exemption amount, the surviving spouse can, in effect, take the deceased spouse’s unused exemption and add it to his or her own. Thus, married couple’s exemptions have become “portable.”

There are complicated details that arise as a result of the portability concept, including what happens when the surviving spouse remarries, and I won’t get into that here. I will only make a few observations about the concept of portability.

With the advent of portability, it will be possible to have all assets of a married couple pass to the surviving spouse and then, at the surviving spouse’s death, apply both exemptions – a total of \$10 million – to the entire estate. Previously, without portability, it was necessary to set aside assets of the first-to-die-spouse at the time of his or her death (in the credit shelter trust) and keep those assets separate in order to utilize the exemption of the first-to-die-spouse.

I suspect that the concept of portability will lead many folks to question the need for “credit shelter” or “bypass” trust planning. Indeed, the increased exemption and the ability to rely on portability will enable some clients to simplify their planning. However, here are some reasons why I expect that many of my clients will want to maintain the benefits of the credit shelter trust planning we have been doing for many years for those of our clients with estates in excess of \$1-2 million:

1. The DSUEA is not indexed for inflation. Thus, if a credit shelter trust is not used at the first death, when the surviving spouse dies the DSUEA will still be \$5 million. Compare that with the use of the credit shelter Trust: if \$5 million is placed in the credit shelter trust at the first death, that \$5 million, plus any

increase in value of the assets in the credit shelter trust, will escape taxation, whether the value is \$5 million or \$50 million.

2. The credit shelter trust we always design for our clients has many non-tax benefits as well: (1) the first-spouse-to-die has assurance that the assets in trust will pass to his intended beneficiaries and will not be lost if the surviving spouse remarries; (2) the assets in the credit shelter trust are secure in the event the surviving spouse develops dementia or Alzheimers; and (3) the assets are kept safe from the surviving spouse's creditors. Relying on portability for tax purposes loses these benefits that our clients typically find extremely valuable.
3. Portability only applies in the context of the federal estate tax law, and does not apply to the Maryland estate tax. Thus, as discussed elsewhere in this article, the use of credit shelter trusts for Maryland residents is *highly recommended* where the estate exceeds \$1 million. Married couples residing (or owning real property) in Maryland need to be reminded that the much talked about tax reforms do not affect the Maryland estate tax.
4. The portability provisions expire in two years, and there is no certainty that they would be retained in any future legislation.

While portability will have the very beneficial effect of avoiding or decreasing estate tax in situations where married couples have not done effective estate planning, I am afraid that many people will get a false sense of security and develop the mindset that their estate planning can be put off to the future. This will, unfortunately, lead to many of the other non-tax problems that can be created by the failure to properly plan. I think it is important to note that clients come to us for estate planning for many reasons that have nothing to do with taxes. These include: (1) making sure their property passes to the persons they desire in the manner they desire; (2) providing their beneficiaries (regardless of age) with protections for their inheritances from divorce, creditors, disability, etc.; (3) designating the people who will ensure that their wishes will be carried out – executors, trustees, guardians and powers of attorney; (4) leaving detailed health care instructions in case they are unable to do so themselves; and (5) leaving instructions for the management of their finances in the event that they become disabled.

3. Reunification of the Gift and Estate Tax- The new \$5 million Gift Tax Exemption

The provision of the new law that was the most surprising to me was the fact that the gift tax exemption was increased from \$1 million to \$5 million. When the 2001 law was passed increasing the estate tax exemption gradually to \$3.5 million, the gift tax exemption stayed at \$1 million. Thus, although you could *die* and leave \$3.5 million tax free in 2009, you could only *give away* \$1 million. It was generally understood that this was done because of the “sunset” provisions that would have returned the estate tax exemption to \$1 million in 2011 if no further law had been passed. After all, if the gift

tax exemption would also have increased to \$3.5 million in 2009 before returning to \$1 million upon sunset, then taxpayers would have been able to “beat the clock” by making large gifts just prior to January 1, 2010, and the Treasury would have lost a lot of revenue.

By increasing the gift tax exemption as well as the estate tax exemption, our wealthier clients now have the ability to transfer \$5 million each (\$10 million per couple) *now*, and get that much out of their taxable estates, together with the appreciation that occurs on those assets. With leveraging techniques, such as Family Limited Partnership planning and various planning using Grantor Trusts, the increased gift tax exemption can provide significant estate tax reduction. I see the opportunity for wealthy clients to not only move substantial wealth out of their taxable estates, but to also accomplish *income-shifting* as well, by utilizing the increased gift exemption. This will be especially useful for clients with assets that are likely to greatly increase (think real estate and business interests).

A big “fly in the ointment” with regard to the gift tax is the temporary nature of the 2010 law. One of the most-discussed issues at the Heckerling Conference I attended was the question of what happens if you make a \$5 million gift in 2011 or 2012, and then the estate tax exemption goes back to \$1 million in 2013 and thereafter? Will the IRS be able to “recapture” the tax on the excess? Opinions differ. My personal opinion as of today is that such a “clawback” would not be upheld. I expect to be advising many clients who have estates in excess of \$5 million, and who feel they can afford to part with some of their wealth, to make substantial gifts (in most cases to irrevocable trusts, not outright to beneficiaries). However, I will be careful to alert them to the possibility of the recapture. After all, even if there is a recapture, the family will be in no worse position than they would be if the gift had not been made, because if the gift had not been made, the assets would still be in the estate. Clients need to be fully briefed on the possible outcomes, and the ultimate decision must be theirs.

4. Two year sunset

Once again Congress has left us to deal with a law that by its own terms is only temporary. This one lasts only two years. So what happens when the ball drops in Times Square on January 1, 2013? Well, unless Congress passes another law, we go back to a \$1 million exemption and a marginal tax rate up to 55%. Well, you say, surely Congress will act before then, right? But isn't that what we all said from 2001 all the way through to December 31st, 2009? As was stated by one of the speakers at the conference I attended earlier this month, *“There's one thing we've learned – you can't make predictions.”*

So, here are some of the things I will be discussing with my clients as I try to lead them through these uncertain waters:

First, and foremost, our planning must focus on the question of who they want their property to pass to at their death. We can no longer blindly draft wills and trusts using

strict “formula clauses” that are tied to exemption amounts when we cannot foresee what those amounts will be. With an increased exemption amount and the portability provisions, many estate plans will be able to be simplified (although, as mentioned above, we still should plan to avoid the Maryland estate tax where necessary).

Second, all clients who have wills and trusts that contain “formula clause” language tied to the estate tax exemption amount (this means any married clients that do not have simple “sweetheart” wills) need to review their plans now. They could find that the results of these formulas would now bring about a result that is entirely different than the result they desire. The results will be much different if the client dies when the exemption is \$5 million than if he dies when it is \$1 million. Given the uncertainty we are facing, in many cases we may want to write the wills and trusts so as to separately state what the result will be under the different scenarios.

Third, we will be drafting flexibility into all our clients’ wills and trusts. I expect to continue to draft trusts that allow us to take a “wait and see” approach to the estate tax using “disclaimer” provisions. In many situations, I will be recommending that the trust document provide for the appointment of a “Trust Protector” or a Special Independent Trustee that possesses certain powers such as the power to amend an otherwise irrevocable trust in order to adjust the trust provisions in order to adapt to changes in the tax laws.

One key area of special importance where flexibility will be of great value is the interplay of the estate tax exemption and the preservation of the “step-up” in basis on inherited assets. To illustrate, when the first spouse dies, if we allocate assets to the credit shelter trust in order to keep those assets from being subject to estate tax in the surviving spouse’s estate, when the surviving spouse dies, there will be capital gains tax on the value of any increase in the credit shelter trust assets over the surviving spouse’s life. As a rule, this is usually not a bad bargain – we give up a capital gains tax of 15% in order to avoid an estate tax of 45%. Well, it may turn out that we don’t care about the estate tax when the surviving spouse dies – maybe because her entire estate, including the assets in the credit shelter trust, does not exceed the then-current exemption amount. In that case, we would rather that the assets in the credit shelter trust *were included* in the surviving spouse’s estate, since they would not cause an estate tax and they would receive a step-up in basis. By including provisions in the trust that give certain powers to the Trust Protector or to a special independent trustee, we would be able to distribute the credit shelter trust assets out of the trust and to the surviving spouse, thus causing estate tax inclusion and a step-up in basis. I expect that this planning feature will be one that my clients will find most beneficial given the new law.

Fourth, as mentioned above, I expect to continue to educate my clients about the many non-tax benefits of proper trust planning – protection against a surviving spouse re-marrying and (intentionally or unintentionally) disinherit the children, protecting against estate plans being wrecked by the mental deterioration of a surviving spouse, protection for their children from lawsuits, bankruptcy and failed marriages, etc.

Finally, since we only know what the law is for the next two years, I will be telling all of my clients that whatever planning we do now, we will need to keep an eye on what Congress ultimately decides to do with the estate tax. Given the short window of the TRA 2010 act, this takes on added importance. Nonetheless, clients should still be urged to have an estate plan in effect that is appropriate for today, even though it may have to be modified later. After all, one thing we can count on – not everybody alive today will be alive on January 1, 2013. In other words, clients should not simply wait until 2013 to do anything.

These are some of my thoughts about the new law. I hope you find them useful. If you have any questions, feel free to give me a call.

Best regards,

James A. Hyatt