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LAWYERS

Estate Planning Under the 2001 Tax Act

Hoffman, Sabban & Watenmaker strives to keep our clients and friends informed of important developments affecting their estate and tax planning. This letter summarizes some of those developments.

Will Repeal Ever Occur?

The new law may never go fully into effect, or if it goes into effect the old law may be reinstated. (The 2001 Tax Act provides that the old estate tax law will be automatically reinstated in 2011 unless Congress again votes to keep it repealed.) It has been projected that the revenue loss from 2010 to 2020 due to repeal of the estate tax will be about $1.0 trillion in current dollars; but that amount has been excluded from the current budget debate because it occurs more than 10 years in the future. Coincidently, in 2011, the first of the "baby boomers" (those born after 1945) will reach age 65 and start to draw social security and Medicare. The number of Americans over 65 will double by 2050 and triple by 2075. The Medicaid bill will jump due to nursing home care costs as well as medical care costs. Medicaid already pays about half of the nation's nursing home costs, and these expenses will soar in coming decades as the population ages. Medicare spending is projected to more than double in the next decade. An article in Business Week's May 21 issue indicated that government health spending (both Medicare and Medicaid) will double in the next 20 years. Spending for medical costs is rising faster than the rate of growth in the number of over 65 persons. In 1970, Medicare spending was $350 per beneficiary; by 2000 it was $5,655; and by 2010 it will be nearly $10,000. If Congress adds a prescription drug benefit to Medicare, the costs will increase even more. The combination of the revenue loss from repeal, plus soaring government costs, may persuade the Congress to stop the phaseout.

Tax collections may fall faster and deeper than Congress has projected. As discussed below, the "lock in effect" may be exacerbated in the future, with people holding onto assets in order to get a stepped up basis at death, and not making taxable gifts. Gift tax revenues will immediately dry up as people decide it makes no sense to make taxable gifts when you could eliminate transfer taxes entirely by waiting until death.

On the other hand, Treasury Secretary Paul O'Neill recently stated that if budget surpluses in the next few years exceed the projections, those surpluses should be used to speed up repeal of the estate tax.

Implications for Gift Giving

There will be an even greater "lock in effect" with respect to sales and gifts than under current law, since at least currently you get a reduced transfer tax on gifts. In the future, a gift will result in a gift tax (that could be avoid by waiting for death), and in a loss of a step up in basis (at least by $1.3 or $4.3 million). Rather than making gifts to children, people will simply loan them money. Gifting will make sense under the new law only up to the amount of the $1 million exemption.

There are three situations where gifts will make sense under the new law, but again only up to the amount of the exemption. First, if an asset is worth less than its basis, a gift will give the recipient a "floating basis" where the recipient will have a taxable gain only if the asset is sold for more than the basis, but will have a taxable loss only if the asset is sold for less than the fair market value at the date of gift. On the other hand, if that depreciated in value asset is retained until death (and not given away during life), the recipient will always get a "stepped down" basis equal to the fair market value at the decedent's death. You would be better to give away such assets (up to the $1 million exemption) unless the decedent has gains exceeding $1.3 or $4.3 million, as applicable, and the "built in losses" can be applied to increase the basis of those assets with excess gains.

Second, a gift up to $1 million (the exemption) can be used to shift the income earned on that gift to a lower income tax bracket family member. Third, such a gift of a low basis asset might be made to an elderly family member who, if he or she lives 3 years, will get a stepped up basis.

Even if people make taxable gifts in the future, few people will report the gifts since there will be no effective enforcement mechanism once the estate tax and the chance of audit is eliminated. (Currently, gift taxes are enforced by the same people who enforce the estate tax, and many gift tax deficiencies are discovered in connection with estate tax audits.) Indeed, even estate tax enforcement probably will drop over the next 10 years since it will be difficult for the government to recruit new estate tax auditors if the auditors know their jobs will be gone in a relatively short time.

One way to maximize the use of your annual gift tax exemption has been to contribute to a qualified state tuition program, commonly called a Section 529 plan, such as California's Scholarshare Program. You can use your current and the anticipated next 4 years of annual exclusion gifts (a total of $50,000) on a current contribution to such a plan, so that the income on all $50,000 starts to accumulate for the beneficiary (not just the current year's $10,000 gift.) Such plans have received an important benefit under the new law. Starting in 2002, all distributions from such plans which are used for qualified higher education costs can be withdrawn by the beneficiary with no federal income tax.

Implications for the States

Many states (including California) have received substantial tax revenues from a share of the federal estate tax (due to the "state death tax credit.") The new tax bill cuts that credit by 25% in 2002, and phases it out by 2005. This will put pressure on the states to raise income or other taxes, or suffer a reduction in their credit rating. California is prohibited (by a constitutional amendment adopted by the voters) from instituting a new inheritance tax.

Insurance Policies

Be sure that your insurance company has adequate reserves. Some companies have derived a substantial part of their profits from selling cash value policies in order to fund expected estate taxes. If people no longer feel the need to keep insurance for that purpose, then there may be an "adverse selection" phenomenon, with healthy people cashing in their policies and ill people keeping their policies in effect.

As the estate tax exemption increases and the maximum tax rate declines, you may want to review the amount of insurance you maintain to provide for estate taxes. Some people may want to cancel their cash value insurance, and substitute 10 year term insurance, but in general we believe that this is not a wise move. It is not clear that we will ever see full repeal. There may be taxable income realized on cancellation of a policy. Cash value insurance may be an important tax planning tool in the future, since cash value isn't taxed as it builds up, in some cases cash can be withdrawn from the policy tax free, and the proceeds can be received tax free (without carryover basis concerns.) Indeed, as people turn their attention from saving estate taxes to saving income taxes, more people may decide to buy "variable life insurance" which allows you to invest in stocks inside the insurance policy. Insurance will also be important to deal with such matters as buy-sell agreements, paying the capital gains tax on sales of assets after death, and equalizing gifts among children where there is a family business passing to some but not all children. If you plan to cancel a policy, and you are over age 65, you may want to investigate the sale of the policy to a viatical settlement company, which may pay you more than the cash value of the policy.

Unwinding Existing Estate Planning Devices

If and when the increased exemptions go into effect or the estate tax is repealed, you may want to consider undoing some estate planning now in effect. For example, if you have assets worth less than the estate tax exemption, you may want to dissolve any family limited partnerships so that the value on death is increased, and you can "step up" the basis to a higher value. You might want to try to terminate existing Bypass and QTIP Trusts in order to save administrative costs and achieve a stepped up basis on the surviving spouse's death.

Many people will want to keep generation skipping trusts in their plans in order to make sure that their assets stay in the family and for creditor protection reasons. However, you might want to reconsider the use of generation skipping trusts, and eliminate them from your estate plan, or try to terminate existing generation skipping trusts, in order to achieve a stepped up basis for the assets in those trusts when the beneficiary dies.

Should You Revise Your Estate Plan?

Many estate plans will **not** have to be revised because of the change in the law, unless and until estate tax repeal actually takes effect in 2010. Almost all estate plans prepared by Hoffman, Sabban & Watenmaker will automatically adjust for the increase in the estate tax exemption. Since August, 1997, we have been anticipating an increase in the exemption to $1,000,000, and the new law will simply increase the exemption to that level sooner than had been anticipated. There are a few cases where you might want to make changes before 2010, and in particular before 2004, due to the anticipated increase in the estate and generation skipping transfer tax exemptions beyond $1,000,000:

Distortion in Plans Due To Increased Exemptions

If you are married and your estate plan leaves an amount equal to the estate tax exemption to your children, grandchildren or friends, with the balance to your spouse, you may want to consider limiting the gift to children, grandchildren and friends to an amount less than the exemption. Otherwise, your spouse may receive too little and your children, grandchildren and friends too much. Similarly, if your plan leaves the amount of your GST exemption to grandchildren, you may want to consider limiting this, since during the period when the GST exemption is increasing, it may leave your children too little and your grandchildren too much; and after repeal it may leave everything to your children and nothing to your grandchildren.

Should You Eliminate The Bypass Trust or QTIP Trust, and Instead Leave Your Assets Outright to Your Spouse?

Many married clients have estate plans that establish a "bypass trust" on the death of the first spouse to die. This is done to preserve the estate tax exemption of the first spouse to die, so that amount can eventually pass free of estate tax to children or others.

If you are married, and if the assets of you and your spouse total less than the estate tax exemption, then you might want to consider eliminating the Bypass Trust and QTIP Trust created under your estate plan, and instead leave your assets outright to your spouse. Alternatively, you may want to grant an independent trustee the right to terminate the bypass trust if your spouse's assets plus the bypass trust assets are less than the exemption, or if and when the estate tax has actually been repealed. There are two reasons why you might want to do this.

First, assets held in a Bypass Trust or a QTIP Trust will apparently not be treated as owned by the surviving spouse at the surviving spouse's death. Thus, if assets are left directly to the surviving spouse, rather than to a Bypass or QTIP Trust, the surviving spouse will be able to "step up" all of the assets at the surviving spouse's death, in addition to getting a stepped up basis at the deceased spouse's death. (This is important both if the surviving spouse dies before repeal, when the surviving spouse's assets get a full step up at death, as well as if the surviving spouse dies after repeal, when the surviving spouse's assets will be able to be stepped up by $1.3 million after death.) However, this may be an oversight in the legislation that will eventually be corrected. Second, eliminating the Bypass Trust and QTIP Trust will also eliminate the need for record keeping and tax return compliance required to maintain a Bypass Trust and QTIP Trust.

On the other hand, a Bypass Trust and QTIP Trust provides some benefits which you may not want to eliminate (even if the estate tax is completely repealed.) These trusts provide creditor protection, and can assure the first spouse to die that when the surviving spouse dies, the assets will pass to the beneficiaries selected by the first spouse to die.

It is interesting to note that the one group who likely will suffer from repeal are the spouses of very wealthy people. Currently, they receive assets free of estate taxes and with a stepped up basis, regardless of amount. After repeal, they will still receive assets free of estate tax, but the stepped up basis will be limited to $4.3 million. As discussed below, even the spouses of the merely well off will probably do less well after repeal, since the first spouse to die may be less inclined to leave assets to the spouse if the first spouse to die can leave all of his or her assets to the children and still avoid estate taxes. This phenomenon is likely to be particularly evident where the children are from a previous marriage.

Should You Increase Bequests to Children?

If you are married, then as the exemption increases, or repeal becomes effective, you may want to reconsider how large a share of your estate you want to leave to (or in trust for) your spouse. If you are married, you will no longer have to leave your assets (in excess of your exemption) to your spouse or charity in order to avoid paying estate taxes. Thus, you might want to leave more to persons other than your spouse.

However, if you are married, then once repeal becomes effective you may want to plan to maximize the use of your $4.3 million basis step-up. While you can allocate $1.3 million of basis increase to any assets, regardless of to whom you leave them, you can only allocate the additional $3 million of basis increase to assets which pass to (or in trust for) your spouse. This may affect how much you leave to your spouse, and which assets you leave to your spouse. For example, you may want to leave your most highly appreciated assets to your spouse, but limit the gift so that only $3 million of appreciation is transferred. But, determining how much to leave to your spouse may be difficult. Assets with $3 million of appreciation may be worth a great deal more than $3 million.

Once you have left appreciated assets to your spouse with a total of $3 million of appreciation, you may want to consider what provisions should govern the rest of your assets. For example, you may want to set up a "sprinking trust" to apportion income among your spouse and children. Your spouse's right to benefit from the trust could terminate if your spouse remarries.

If repeal becomes effective, provisions for charity should be reviewed, and this will affect how much you leave your children. If you no longer have to pay about half of your assets in estate taxes, you may conclude that your children will receive from you more than you would want them to inherit, and thus you might want to consider leaving more to charity. On the other hand, since you will not get a tax benefit from leaving assets to charity, you might want to leave more to your children (who will then get an income tax deduction for amounts they give to charity during their lives.)

Married people who have left assets to children at the first death should consider revising the plan to instead leave assets to the surviving spouse. If the first spouse dies before repeal, the assets will be subject to estate tax; but if you put the assets in a QTIP, the children will be deprived of income for some years but may benefit from receiving the assets with no estate tax.

On the other hand, after repeal, a problem with leaving "too much" to your spouse is that your children may be in lower income tax brackets than your spouse, and if your children need funds after your death your spouse may have to pay gift taxes in order to get those assets to your children. On the other hand, if you leave the assets to your children at your death, then there would be no estate tax and the income may be subject to lower income taxes.

Bequests to Non-Citizen Spouses

Under current law, gifts to a non-citizen do not qualify for an unlimited gift tax marital exemption, but rather qualify for a $100,000 annual gift tax exemption. This provision will remain in effect under the new law. Under current law, bequests to a non-citizen spouse are subject to estate tax unless (a) the surviving spouse becomes a U.S. citizen before the deceased spouse's estate tax return is filed, or (b) the bequest is left to, or transferred by the surviving spouse to, a Qualified Domestic Trust ("QDT"). This will remain the law until the estate tax is repealed; but after the estate tax is repealed there is no estate tax so there will no longer be a need for a QDT. Nevertheless, if a QDT is established before the estate tax law takes effect, then principal distributions from the QDT to the surviving spouse during the surviving spouse's life but before 2022 will be subject to estate tax even after the estate tax law is repealed. Presumably, this was out of a concern that the estate tax law might remain repealed only for one year (2010) and be automatically reinstated under the "sunset" provision in 2011. In that case, the estate tax could have been defeated by making principal distributions to the surviving spouse during 2010. The surviving spouse could then give up his or her U.S. domicile (if he or she has one) and make gifts free of U.S. tax. Further, by keeping the QDT intact, there is a greater chance of the U.S. being able to collect income taxes on the income of the trust.

In view of the problems for non-citizen spouses, we continue to believe that it is advisable, for gift and estate tax reasons, for a married U.S. resident person to become a U.S. citizen.

Bequests to Non-Resident Aliens

Another problem raised by the new tax law affects U.S. persons (both citizens and residents) who, after 2009, wish to give assets to non-resident aliens at death. Under the new law, a transfer at death (but not during life) to a non-resident alien will be treated as a sale, if the transfer occurs after 2009. Thus, it might make more sense give away such assets to your non-resident alien friends or relatives, if after estate tax repeal you have assets which can't enjoy a full basis step up, and you want to have them benefit from the assets. Note also that under the new law, any transfer of assets with liabilities in excess of basis at death generally won't be a taxable event, but there is an exception which does generate taxable gain if the transfer is to a foreign person.

Implications for IRD

Under current law, items of income which haven't been subjected to income tax at death (known as income in respect of a decedent, or "IRD") are subject to double tax after your death (both income tax and estate tax). The effective tax rate on these IRD items can exceed 80%. The effective tax rate on IRD will decline under the new law for two reasons. First, prior to complete repeal, if the state death tax credit is repealed, your tax bill may drop. The federal income tax allows a deduction for the portion of the estate tax paid to the federal government (i.e., after the state death tax credit), but not for the portion of the estate tax paid to the state; and California (and some other states) do not allow a deduction for estate taxes paid to either the federal or state government. Thus, if the state death tax credit is reduced or eliminated, more of your estate taxes will go to the federal government, thus increasing the estate tax deduction on your income tax return. Second, the estate tax rate and the income tax rate will be less under the pending bill.

Some people have decided to leave their retirement plan benefits (which are IRD items) to charity, rather than to their children or friends, because of the high rate of tax imposed on these items. Under the new law, people may want to rethink this planning. If the estate tax is repealed, or if your exemption is greater than the amount of your assets (including retirement benefits), then the only tax that will be paid on these benefits will be the income tax; and that tax is only imposed as and when benefits are withdrawn from the retirement plan. Thus, since the income earned on retirement plan assets can be "sheltered" inside the plan until they are withdrawn, it may be preferable to leave these benefits to children and relatives, rather than leaving them to charity.

Drafting Pending and After Repeal

It will be hard to draft a good estate plan in the next years. Should you leave more to the spouse, in order to maximize the chance for a step up at death, or keep the maximum exempt amount in a bypass trust (assuming the survivor will have more than the exempt amount) in case the surviving spouse dies before repeal?

After repeal (if we ever get there), how should you draft a plan? Leaving more to the kids at the first death reduces the chance for a step up at death. After all, to maximize benefits, the amount you leave to the spouse won't be, say $3.0 million, but rather assets with $3 million of gain (which likely would be far more than $3 million.) How do you draft for that?

Should you draft a marital trust with a provision terminating the spouse's benefits on remarriage or cohabitation, recognizing that such a provision would prevent a $3 million basis increase?

Who Decides On Basis Increase Allocation

There may be an importance to deciding who is the executor. Basis increase is allocated by the executor. The allocation decision applies to all assets, including joint tenancy assets. Thus, if some assets pass by joint tenancy to persons other than those who benefit under the will or trust, and the amount of the possible basis increase exceeds $1.3 million or $4.3 million, as applicable, then the executor is likely to (and may have an obligation to) allocate the increase solely to the assets passing under the will or trust. Suppose the will isn't admitted to probate because all of the assets are in a living trust or pass by joint tenancy? Who has the power to make the allocation? You may want to include a power in your estate planning documents authorizing the trustee to make the allocation if there is no executor, and releasing the executor from liability for his or her decisions regarding the allocation.

Copyrights

Under the new law, assets generally get the same nature in the recipient's hand as in the decedent's hand. The creator of a copyrighted work always has ordinary income on a sale of the copyright. Under prior law, on the death of the creator, the heirs or beneficiaries would get a new income tax basis and be able to treat further gains as capital in nature. There is a special exception in the new law to preserve the capital gains part of this "old law" treatment for copyrights, so they will get a capital gain status in the hands of a beneficiary of a decedent even if no basis adjustment is made.

Income Tax Planning Post Repeal

"Basis strips" likely will become the planning technique of choice for people with assets with gain in excess of the step up exemption. Suppose a person has a valuable, low basis asset. The person will borrow money secured only by the asset, use the cash to make other investments, and then at death leave the original, encumbered, asset to an otherwise worthless corporation. The lender can then foreclose on the asset, generating taxable income for the corporation, and the corporation will go bankrupt owing income taxes to the taxing authorities which it will never pay. The Service is granted authority to adopt regulations to prevent tax abuse under the rule regarding transfers of assets with liabilities in excess of basis, and this may be the type of transaction which will be covered by the regulations.

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