Until the Other Shoe Drops

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ABSTRACT

Estate tax uncertainty brings with it a variety of planning concerns. We examine those concerns and suggest ideas that should be considered now and in the future.

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As I write this column in June, I realize that by the time it's published in the September 2017 issue of the *Journal of Financial Service Professionals,* we may have tax reform legislation percolating through Congress. The gap between the time when a column like this is written and when it is published necessarily means that it doesn't address breaking news. The acceleration of the news cycle caused by various electronic media dictates that the latest word on a given topic, right or wrong, carefully supported or hastily improvised, happens at an ever-increasing speed. In contrast, this column deals with estate planning, a topic that most people would just as soon deal with well after tomorrow. So, when you read this, it may well be passé when compared to new speculation about the direction of the tax law generally and the future of the federal estate tax law in particular. However, at the moment, it looks like it will be a while longer before Congress passes new tax legislation that the president will sign into law.

Background

In 2001, the Economic Growth and Tax Relief Reconciliation Act introduced major increases in the federal estate tax exemptions that, in a series of jumps, increased from $1 million in 2002 to $3.5 million in 2009. We actually had one year—2010—in which federal estate taxation could be avoided for any decedent if the executor elected to give up the income tax

advantage of a stepped-up basis. Without the election, in 2010, the exemption became $5 million. Indexing of the exemption with cost-of-living increases was added to the law, effective in 2012. At the end of 2012, there was widespread concern among estate planning advisors that the $5 million-plus exemption might revert to $1 million if legislation were not enacted. Congressional horse-trading ensued to leave taxpayers with income tax increases, and the $5 million-plus exemption remained intact with more indexing to follow, per the American Taxpayer Relief Act. For the past several years, planning has continued with the thought that the estate tax system seemed to be permanent. At some point (soon?), we find out whether that permanence was only temporary after all.

It's hard to plan when the rules keep changing or threatening to change. Of course, even if the estate tax is actually repealed, that doesn't mean that its disappearance is the final word. The tax might be repealed and reinstated. Of course, that already happened. We might stay in a position similar to when we had the jumping exemptions of the George W. Bush years and the possibility of repeal. The strategy then, and now, would be to maintain as much flexibility as possible in the face of ongoing uncertainty. In anticipating possible tax law changes, it is important to consider just how concerned a given client may be with the prospect that their beneficiaries will be subject to federal estate taxation. Just as income tax rates have fluctuated substantially over a long period, it remains possible that estate tax could be increased in the far future, even if threatened to end altogether in the near future. While that prospect is not now before us, we should keep in mind that a vast amount of the population need not pay attention to the estate tax. Under the current law, less than 1 percent of the larger population will wind up with estate tax paid by their heirs.

The Silent Majority

In sizing up the best approach to estate planning in the near term, let's remember that a certain percentage of your clients now sit with wills, trusts, and/or patterns of asset ownership and beneficiary designations that could probably stand improvement. Nonetheless, only a fraction of those who should take action will take action anytime soon. It seems that if an individual has 10 things to do, estate planning concerns often wind up in the 11th place or worse. Eventually, a new federal tax law will emerge of whatever shape and scope. When it does, it will bring with it a host of both financial and estate planning strategies for clients to consider. A change in the tax law is often a catalyst that produces a focus of attention on personal planning issues that have been long deferred or neglected. Without the stimulus of tax legislation, many individuals will be unmoved to deal with estate planning, short of reminders of mortality intervening, as when the infrequent flyer contemplates a plane ride.

Disclaimer Trusts Offer Flexibility

Let's suppose that you must now advise a client who believes that estate tax planning should be addressed. Even if one assumes that the current estate tax law will remain unchanged, projections involving asset values and life expectancy must be considered, along with the fact that estate tax exemptions are indexed.

Many clients have done estate tax planning in the past with marital/nonmarital trusts that are no longer advisable because the larger estate tax exemption now available results in having too much value in the nonmarital trust. For example, suppose that a married couple has combined gross estates of $7 million, with the bulk of the value in one spouse's name. If that spouse dies first, the surviving spouse might not appreciate having $5.49 million (or more, as indexing raises the exemption) held in a nonmarital trust, with only the remaining $1.51 million in the survivor's direct ownership. That may be a dramatic case to make a point, but the larger point is that, over time estate tax planning may fade as a concern for some clients and remain relevant, or grow in significance, for others. Many clients do not want to conduct a regular review of how their asset values stack up against an increasing estate tax exemption, unless other circumstances require an update.

The logical solution for those who might or might not have an estate tax concern is to have each spouse leave all assets to the other spouse, with a disclaimer trust included in each will (or within a revocable trust) as a fallback solution, which provides great flexibility. In the example of the couple with $7 million, the surviving spouse can decide how much of the decedent's bequest to accept and how much to disclaim to a nonmarital trust. Following a spouse's death, many of the uncertainties that clouded the planning outlook for the couple have been removed. The value of the decedent's estate, the available exemption upon death, and the current status of the tax law are more clearly established and permit the survivor to decide how to proceed with estate planning for the future. Naturally, the survivor still must make judgments as to the relative importance of estate tax planning and take financial needs and life expectancy into account. That process may not be easy for one who is widowed, but the range of choices available with the all-to-spouse/disclaimer trust strategy offers great flexibility. The fact that assets can be disclaimed as to a specific amount, that the decision can occur over a 9-month period following a spouse's death, and that, ideally, advice from those professionals on the estate and financial planning team can be available, enables the survivor to capitalize on the inherent flexibility of the plan. Of course, it should be emphasized that the planning for a possible disclaimer should be conducted while both spouses are alive. Keep in mind that a transfer of an asset to a disclaimer trust occurs by default upon the survivor's refusal to accept ownership of the asset. The terms of the disclaimer trust, beneficiary designations, and pattern of asset ownership must be organized while both spouses are alive to permit a suitable range of choices to be available when one of them dies later.

Power to Amend by Trustee or Third Party

It may happen that the federal estate tax law will be repealed and subsequently reinstated. Even if the federal gift tax law continues while the estate tax law is eliminated, the gift tax exemptions or rates may be changed in a major way, or not altered much, over time. In addition, income tax rates for individuals and trusts may be subsequently changed in response to political turnover in Congress or the presidency, as well as changes in the economy. That may mean that certain estate planning techniques that are favorable today and designed for the longer term may lose their advantage as tax law provisions are amended in the future.

For example, sales to irrevocable grantor trusts are often triggered on the premise that the grantor of the trust is considered its owner for federal income tax purposes, but not for federal estate tax purposes. The elimination of the federal estate tax or a major change in federal income tax rates may disrupt the tax and financial advantages that the trust grantor set out to achieve over the longer term. The terms of an irrevocable grantor trust or other trusts geared to a tax-planning objective may include a provision that authorizes the trustee, or a third party acting in a nonfiduciary capacity, to amend or even terminate a trust that may no longer serve that objective. Perhaps the person other than a trustee is classified as a trust protector under state law or is simply another person who is informed of the trust's purposes and is qualified to take suitable action for the beneficiaries, with appropriate coordination with the trustee. However it is accomplished, the governing document may contain a mechanism to have a qualified individual or institution make adjustments that will be suitable for a grantor's beneficiaries as the law may evolve and circumstances may change.

Collateral Benefits

You might pursue an advanced estate planning technique that has significant benefit for your clients even if estate tax planning isn't needed. For instance, the sale to an irrevocable grantor trust, as described previously, can be a great way to accumulate funds for the next generation with distributions possibly made to the beneficiaries as they become young adults.

Both the parents and the children can have the benefit of having funds distributed to enable the purchase of a home, the pursuit of graduate or professional education, or the funding of a business to be made by distributions from the trust. A sale to the trust can be a financially disciplined way to transfer assets for the lifetime enjoyment of both parents and children with tax advantages apart from estate taxation.

Also, we have seen last-to-die life insurance in an irrevocable trust provide a substantial benefit for children and grandchildren that may permit larger charitable gifts to be made from an estate otherwise subject to estate tax. A client with substantial means might view the insurance as a favorable means of ensuring an inheritance that is free of estate or income taxation to beneficiaries. Other assets included in the client's estate, regardless of whether it is subject to estate tax, can be sufficient to support a long retirement period and fund charitable causes during life or following death. ■

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