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LAWS AND ESTATES

The Estate-Tax Dilemma

A return to 2001 rules in 2011 creates numerous planning issues.

It's estimated that more than $4 trillion in federal tax provisions will expire by 2011, including significant estate-tax provisions. The president has said that he wants a permanent estate exemption of $3.5 million and a flat estate tax of 45 percent. Advisors should expect Congress to take up the issue this year—probably by early to mid-summer.

Will Congress go along with the president's proposal? The economic meltdown has significantly raised the deficit. Will Congress see the estate tax as a treasure trove of revenue? After all, the dead do not complain about taxes. While polls indicate that most Americans want to eliminate the estate tax, less than 1 percent of all estates pay an estate tax, and higher exemptions could be sacrificed for broader-based tax reform, like an overdue reform of the alternative minimum tax or broader-based tax provisions.

Despite the recession, wealth has exploded over the last three decades. Although estate taxes comprised only about 1 percent of the federal revenue during the 1990s, this percentage could grow as Baby Boomers and their parents die and pass trillions of dollars over the next 40 years. Given the concerns that most elderly Americans have taken more money from entitlement programs than they have put in, some in Congress may view the estate tax as a generational repayment.

But if an agreement cannot be reached, we could return to 2001's tax rules in 2011. If Democrats propose legislation that is unpalatable to Senate Republicans, they could filibuster the bill. Congress may refuse to deal with the issue and allow tax benefits to expire in 2011, creating significant increases in income and estate taxes.

But what about 2010? If permanent transfer-tax legislation is not adopted by the end of this summer, Congress, with Republican support, will probably adopt legislation to carry the 2009 transfer-tax rules across 2010. But could Republicans filibuster that proposal? If they do, it will not have much of a revenue impact. With less than 1 percent of all decedents paying an estate tax from 2006 to 2009, the loss of estate tax revenue in 2010 could be quickly recovered by the return of the 2001 tax rules in 2011.

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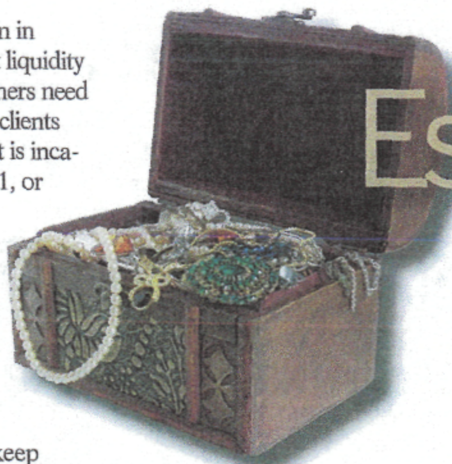
Return to the 2001 rules

Without the adoption of permanent legislation by the end of 2010, the payment and collection of federal estate taxes will skyrocket in 2011. The federal estate-tax rate could be 55 percent for estates above $3 million. Estates valued at more than $10 million could pay an additional 5 percent surtax designed to eliminate the benefit of the marginal estate-tax rates below 55 percent. The 5 percent surtax stops once the estate's value exceeded $17,184,000.

The combination of reduced estate-tax exemptions and a higher estate-tax rate can have a significant impact on clients, even in lower-valued estates. For example, assume that a single taxpayer has a $1.5 million estate in 2009, growing at 5 percent annually. In 2009 and 2010, no estate tax is due, but in 2011, the death tax could be almost $280,000. The percentage of the estate passing to heirs will drop from 100 percent to 83 percent, and even though the value of the estate will grow each year thereafter, the percentage that will pass to family members will decline each year due to the increased tax rate imposed on each dollar of growth. At higher estate values, the estate tax and the reduction in the value of the bequests will be even more severe.

If these higher tax rates return in 2011, they will create significant liquidity problems for many clients. Planners need to start raising these issues with clients *today.* What happens if the client is incapacitated between now and 2011, or becomes uninsurable?



Estate Taxes

Treatment of insurance

Clients who decide to buy additional life insurance to cover this contingency should consider placing the insurance in an irrevocable life insurance trust (ILIT) to keep the death proceeds outside their taxable estate. Because of the current legislative uncertainty, it may be appropriate to adopt contingency formulas in the insurance trust to provide for passage of assets in various scenarios.

For example, if insurance is held in an ILIT but is unnecessary to provide estate-tax liquidity to the estate, a formula provision in the ILIT or the will could pass assets to the client's favorite charity. Prudent planners seeking flexibility should also include limited powers of appointment in virtually every ILIT.

Many clients have estates, including life insurance, in the range of $1 million to $2 million. Many planners have advised clients that given a federal estate-tax exemption of $2 million to $3.5 million each ($4 million to $7 million collectively for a couple), they did not need to place their life insurance in an ILIT because the individual estate tax exemption and/or the joint exemption of the married couple would produce a nontaxable estate. However, a return to a $1 million estate-tax exemption could mean that many clients will have a taxable estate, with the result that 41 percent to 55 percent of the insurance proceeds could be lost to federal estate taxes.

If a client is going to move an existing life insurance policy out of a taxable estate by 2011, the three-year look-back provisions of Section 2035(a) mean that the transfer should occur at least three years before the beginning of 2011. That date, Jan. 1, 2008, has already passed. Even so, clients would be wise to make transfers sooner rather than later, to start running the three-year deadline.

Qualified retirement assets

With the higher exemptions and rules permitting nonspousal heirs to make withdrawals from inherited IRAs and retirement plans over their lifetimes, many estate plans have provided that the retirement plan will pass to younger family members to take advantage of their longer life expectancy while passing other assets to a surviving spouse.

What happens if the reduced exemption causes the retirement assets to be taxable? Assume a client in a second marriage had a $1.5 million IRA and $2 million in other assets. Under his current plan, the IRA passes to his children from a prior marriage while the $2 million is held in a QTIP trust for his current wife. If he dies in 2009, no estate tax would be due, assuming his spouse survives him. On the other hand, if the client dies after 2010, a federal estate tax of approximately $200,000 could apply to the transfer of the IRA to the children. If the children withdraw funds from the IRA to pay the $200,000 in estate taxes, they will create a taxable income of $200,000. If the children then withdraw additional sums from the IRA to pay the income taxes, they will incur additional income taxes. Each withdrawal from the IRA to pay tax will create a new tax. The plan should be revised either to:

- Reduce the IRA bequest to the available exemption
- Pass other assets (e.g., a life insurance policy) to the children to pay the estate-tax liability
- Or pass nonIRA assets to the children, while passing the IRA to the surviving spouse, perhaps in trust.

Unfortunately, no one can predict with any certainty what Congress is going to do with the transfer-tax rules in the next three years. Virtually every estate plan will have to be re-examined in the next three years either to account for a return to 2001 or to deal with the terms of any permanent legislation that is passed.

Who benefits from this chaotic environment and the return to 2001? Several groups will reap the greatest rewards: Roughly half the states that remain coupled to the federal estate tax could receive an unexpected revenue boost. Charities will see increased estate contributions (particularly of IRD assets) to avoid estate taxes. Fee-based planners who provide estate planning advice and estate attorneys will be inundated with work. CPAs will have more tax returns to file. The insurance industry should see substantial increases in life insurance sales to fund estate-tax liabilities. Politicians will see increased contributions to their campaigns. And the client/taxpayer? He'll be paying for all of it. □

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