Icarian Estate Planning: Risks and Opportunities in the 2001 Tax Act

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The Economic Growth and Tax Relief Reconciliation Act of 2001 both entices and threatens the client seeking to safeguard an estate. At minimum counsel must review the estate plan and be prepared for an abrupt shift if Congress does not revise the law again before 2011.

On June 7, 2001, President Bush signed into law one of the most sweeping tax reforms in history. Entitled the "Economic Growth and Tax Relief Reconciliation Act of 2001, the act was touted by the Bush Administration and its supporters as a panacea tax reform that would eliminate the "death tax," eliminate "double taxation," save the "family farm," and save the "small business" while at the same time stimulate the slowing economy. However, if one looks beyond the rhetoric to the text of the act it is apparent that it is not a panacea for all. This is especially true for most estate planning clients. For them the act is better characterized as a poorly crafted, politically motivated two-edged sword. On the one hand, it may create estate-planning opportunities for some clients. On the other hand, it will undoubtedly wreak financial and personal havoc with most existing estate plans. For estate planners, lawyers, accountants, and financial planners the act will only increase their work loads. The act will require a review of all existing wills, trusts, and estate plans and a revision to most.

Effects on Taxation of an Estate

In 2001, estates having a value in excess of $675,000 are subject to estate tax. The act gradually increases that threshold from its current level to a maximum amount of $3.5 million in the year 2009. Therefore, with proper planning, a husband and wife with a combined estate valued at $7 million dying in the year 2009 will pay no estate tax. In addition, under prior law the maximum marginal estate tax rate was as high as 55 percent (60% in some cases[1]). Under the act the maximum marginal estate tax rate is gradually reduced from its current level to 45 percent in the year 2009. In the year 2010, the estate tax is eliminated.
One of the most important aspects of the act that is not widely known, publicized or reported is that the act "sunsets" in 2011. That is, the estate, gift and generation-skipping transfer tax laws as they existed prior to enactment of the act are automatically reinstated in 2011 unless Congress affirmatively acts before that time.[2] Below is a chart showing the increases in the estate tax threshold for single persons and married couples as well as the decreases in the maximum estate tax rates over the next few years:

Estate Tax Thresholds

Year of Death	Total Value of Assets Escaping Estate Tax for a Single Person	Total Combined Value of Assets Escaping Estate Tax for a Married Couple	Maximum Marginal Estate Tax Rate
2002	$1,000,000	$2,000,000	50%
2002	$1,000,000	$2,000,000	50%
2003	$1,000,000	$2,000,000	49%
2004	$1,500,000	$3,000,000	48%
2005	$1,500,000	$3,000,000	47%
2006	$2,000,000	$4,000,000	46%
2007	$2,000,000	$4,000,000	45%
2008	$2,000,000	$4,000,000	45%
2009	$3,500,000	$7,000,000	45%
2010	estate tax is eliminated		
2011*	$1,000,000	$2,000,000	55% [3]

* *In the absence of Congressional action.*

Possible Effects on an Estate Plan

The act may require clients to change their existing estate planning documents. The act also provides some new estate planning opportunities. Below is a list of concerns and opportunities to consider:

Testamentary Trusts. Most estate plans provide for the establishment of trusts upon death. Most of these trusts are funded by reference to the estate tax exemptions, (*e.g.*, the "applicable exclusion amount" and the "generation-skipping transfer tax exemption"). Some of these testamentary trusts are more restrictive than others. Because the new law dramatically increases the estate tax exemptions, a client's existing estate plan may inadvertently over or under fund these trusts on death.

Recommendation. All estate planning documents that contain testamentary trusts that are to be funded by reference to estate tax exemptions should be reviewed. Some of the more common forms of trusts that will require attention are: 1) Family or credit shelter trusts; 2) Marital trusts; 3) Generation-skipping transfer tax trusts.

Testamentary Charitable Planning. Many estate plans provide for gifts to charity on death. Charitable gifts may be either outright or in trust (*e.g.*, testamentary charitable lead annuity trusts). One of the major advantages of these charitable gifts is that an estate receives a deduction that reduces or, in some cases eliminates estate tax. If the estate tax is eliminated after 2009, however, there will no longer be any tax advantage to these charitable gifts. Of course, the philanthropic benefit will still remain.

Recommendation. All estate planning documents that contain testamentary charitable gifts or trusts should be reviewed. If they contain gifts to charity and a primary motive for making the gift was to save estate taxes, then consideration should be given to reducing or eliminating the charitable gift.

Estate Planning for Incapacity. The estate tax is not repealed until 2010 and is reinstated in 2011 in the absence of congressional action. Therefore, clients may want to consider modifying their estate plans for the possibility that they may die before 2010 while there is still an estate tax, in 2010 when there is no estate tax, and after 2010 if the estate tax is reinstated. Contingency planning may be critical for those clients who are older, who are in poor health, or who may become incapacitated in the next few years. This type of estate planning will be expensive and require significant modifications to existing estate plans, but it may be the only alternative for some clients.

Recommendation. All clients, no matter what age, but especially older clients, should have their estate plans reviewed and possibly updated to provide for possible contingencies under the act. Change is difficult, if not impossible, after clients become incapacitated.

Opportunities for Junior Family Members. Under current law a gift from a grandparent to a grandchild is subject not only to gift and estate tax but also to a separate "generation-skipping transfer tax." Current law provides for an exemption from this tax of $1,060,000. The new law increases this exemption to $3.5 million in 2009. The increase in the generation-skipping transfer tax exemption offers significant planning opportunities for those who want to provide more for grandchildren and future generations while still providing for children during their lifetimes. Generally, planning in this area is done with trusts. These types of trusts are called "generation-skipping trusts" ("GSTs") or "dynasty trusts". In Minnesota, these types of trusts can last for as long as the law allows, called the "perpetuities period." In some states these types of trusts can last forever.

Recommendation. If clients want to provide greater benefits to grandchildren and future generations then they should consider establishing a generation-skipping trust during their lifetime or in their estate plan at death. Those clients who already have generation-skipping trusts incorporated into their estate plans should consider amending their estate plans now to state a specific dollar amount that will fund these trusts at death, otherwise they may be over or under funded, and after 2009 no GST trust will be established at all.

Opportunities for Lifetime Gifts. The act did not eliminate the gift tax. However, it did dramatically increase the lifetime gift tax exemption from $675,000 to $1 million. This exemption increase is effective in 2002. Because the estate tax is not scheduled to be

eliminated until 2010 and will be reinstated in 2011 without congressional action, it is recommended that clients take advantage of the increased gift tax exemption *now* by making lifetime gifts to children and grandchildren.

Recommendation. Clients should consider the following estate planning techniques now to gift as much value for the least cost to children, grandchildren, and future generations as a hedge against Congress reinstating the estate tax in the future, or as a "freeze" technique to shift potential appreciation to junior family members: 1) family limited partnerships; 2) grantor retained annuity trusts; 3) qualified personal residence trusts; and 4) irrevocable life insurance trusts.

Flexibility is Key. Estate planning is easier when there is certainty, both in the law and in family dynamics. The estate and gift tax provisions in the act are anything but certain and settled. In fact, they are fluid and it is more likely than not that they will be changed again in the near future. In this author's opinion, the act is a moving target for clients and the best way to effectively plan is to incorporate as much flexibility into estate plans as possible. Two common estate planning tools that provide flexibility are the "disclaimer" and the "power of appointment". Both of these estate planning tools are discussed below.

Disclaimer Planning. A "disclaimer" under Minnesota law is defined as a written instrument which declines, refuses, releases, renounces or disclaims an interest which would otherwise be succeeded to by a beneficiary.[4] In addition to state law disclaimer rules, there are estate and gift tax disclaimer rules under the Internal Revenue Code of 1986 ("Code"), that must be considered, otherwise adverse tax consequences may follow.[5] A disclaimer is often incorporated into a "disclaimer trust will" to allow a surviving spouse to "fund" a trust that is exempt from estate tax. A disclaimer trust will is not new and has been used in the past by many clients with estates of moderate size, or for younger clients where estate tax is a possibility but not a probability and flexibility is paramount. The disclaimer trust will provides the surviving spouse with more flexibility than wills that mandate the creation and funding of testamentary trusts. With a disclaimer trust will, a surviving spouse can make informed decisions based on current tax law and financial conditions. Because the act dramatically increases estate tax exemptions over the next few years, a disclaimer trust will may be the best interim planning vehicle for even larger estates.

Recommendation. Consider incorporating disclaimer planning into a client's existing estate plan to provide flexibility.

Powers of Appointment. Another way to provide flexibility in an estate plan is by the use of "powers of appointment". A power of appointment is defined in the *Restatement (Second) of Property* as "authority, other than as an incident of the beneficial ownership of property, to designate recipients of beneficial interests in property"[6].

Powers of appointment can be exercised during life or at death, in a will or trust. A testamentary power of appointment provides flexibility to the power holder to decide where property is to pass on death. The exercise of a power of appointment has estate and gift tax

consequences.

Under the Code, all powers of appointment are divided into two broad categories, "general" powers of appointment ("GPOA") and "special" powers of appointment, ("SPOA"). A GPOA is construed broadly under the Code. It is defined as "a power that is exercisable in favor of the decedent, his [or her] estate, his [or her] creditors, or the creditors of his [or her] estate."[7] In general, an SPOA is the opposite of a GPOA. It is a power that is exercisable in favor of a person or class of persons other than the decedent, his or her estate, his or her creditors, or the creditors of his or her estate.

Again, because the act dramatically increases estate tax exemptions over the next few years, the use of a power of appointment in a will or trust may provide the surviving spouse with the needed flexibility to appoint assets to children or issue to maximize estate or income tax savings in an uncertain tax environment. For example, it may be appropriate to appoint assets pursuant to a special testamentary power of appointment to less wealthy children who, because of the increase in estate tax exemptions, will not have to pay estate tax where before the act they did. If the estate tax is repealed in 2010, a power of appointment may be a good income tax planning tool. After 2009 the act eliminates the "step-up" in tax basis to fair market value for most assets. Therefore, it might be appropriate for the surviving spouse to exercise a testamentary power of appointment to appoint low basis-high value assets to children, or other appointees, who are in a low income tax bracket or who have accumulated capital or other losses that can be used to offset a gain on the subsequent sale of the appointed property. Remember, after repeal of the estate tax in 2010 most assets will pass to beneficiaries with a "carryover tax basis."

Another income tax planning opportunity using powers of appointment is like-kind exchanges. Under Code section 1031 certain types of property can be "exchanged" for similar property without having to currently recognize an income tax gain on the exchange<V>8<P>. These types of tax deferred "like-kind" exchanges may be available to some appointees under a power of appointment and not to others. For example, one child may want to acquire a parcel of investment real estate that would otherwise require a substantial cash outlay. A like-kind exchange may be attractive to the seller. If the surviving spouse appointed qualifying like-kind real estate to such child pursuant to a testamentary power of appointment, the transaction could be consummated and taxes saved.

A word of caution must accompany planning with powers of appointment. If an estate plan incorporates a power of appointment it may be necessary to provide "counter-balancing" provisions to equalize distributions to other beneficiaries.

Recommendation. Consider incorporating a special or general power of appointment into estate plans to provide flexibility.

Recommendation. Consider incorporating "gift equalization" provisions into estate plans where one child will receive more because of the exercise of a power of appointment.

Conclusion

The Economic Growth and Tax Relief Reconciliation Act of 2001 provides hurdles as well as opportunities for estate planning clients. The act creates at least four distinct planning phases that must be reviewed with every client, namely: 1) planning under the act today when estate tax exemptions are relatively low; 2) planning over the next few years when estate tax exemptions increase dramatically; 4) planning for the eventual repeal of the estate, gift and generation-skipping transfer tax, when income tax "carryover basis" rules replace the current estate tax rules for most assets that provide for "step-up" to fair market value at death; and 4) planning for the possibility that the act will sunset in 2011 and we will return to our current tax system.

Flexibility in all estate plans is the key. Therefore, every estate plan should be reviewed and planning options discussed with clients now. Disclaimer trust wills and powers of appointment should be considered in every estate plan. A tax alert or flyer sent by the firm to all existing clients describing the act and urging them to review their estate plans with their lawyer is a must.

Planning requires action. So it is every estate planning lawyer's job to compel clients to seek their advice now. Whoever posited that the elimination of the "death tax" would be a death knell for estate planners was clearly off the mark. The act will do the opposite, and is clearly a "shot in the arm" for estate planners.

SIDEBAR

Estate , Gift, and Generation-Skipping Transfer Tax Provisions

The act is significantly different in tax years before 2010 than in the tax year 2010 and years thereafter:

Provisions Applicable Before 2010.

- The amount exempt from estate tax -- the "applicable exclusion amount" -- is gradually increased from its current level in 2001 of $675,000 to $3.5 million in 2009.[9]
- The maximum marginal estate tax rate is gradually decreased from its current level in 2001 of 55 percent (60% is some cases [10]) to 45 percent in 2009.[11]
- The amount exempt from generation-skipping transfer tax is gradually increased from its current level in 2001 of $1,060,000 to $3.5 million in 2009.[12]
- The act did not eliminate the gift tax. It did, however, increase the lifetime gift exemption [13] from its current level of $675,000 to $1 million in 2002 and thereafter.[14]
- The maximum marginal gift tax rate is gradually reduced from its current level of 55 percent (60% is some cases [15]) in 2001 to 35 percent in 2010.[16]

Provisions Applicable in 2010.

- The exemption for gift tax remains at $1 million.[17]
- The estate tax and generation-skipping transfer tax (hereafter collectively referred to as "estate tax exemptions") are eliminated.[18]
- Except as noted elsewhere in this article, beneficiaries of assets inherited from a decedent will no longer get a "step-up" in the tax basis of those assets to fair market value at death. Beneficiaries or heirs at death will instead have a "carryover" tax basis.[19] In effect, the income tax replaces the estate tax.
- $1.3 million in assets can pass to any beneficiary or heir and get a "step-up" in tax basis to fair market value.[20]
- $3 million in assets can pass to a surviving spouse and get a "step-up" in tax basis to fair market value.[21]

Notes

1 See *Code ¤ 2001(b)(2).*
2 See *Sec. 901 of the act.*
3 See *Code ¤ 2001(b)(2). The maximum marginal rate is increased from 55% to 60% under certain conditions.*
4 See *Minn. Stat. ¤ 525.532 Subd.1(c) .*
5 See *Code ¤ 2518 and the Treasury Regulations thereunder. A "qualified disclaimer" must meet the following tests: 1) it must be in writing; 2) it must be received by the transferor within 9 months of death, and; 3) the transferor must not accept any benefits. In addition, Treas. Regulations 25.2518-2(e) provides that a disclaimer is not a qualified disclaimer if the disclaimant retains a power of appointment over such property unless such power is limited by an ascertainable standard.*
6 See *2 Restatement (Second) of Property ¤ 11.1 (Donative Transfers) (1986).*
7 See *Code ¤ 2041(b)(1).*
8 See *Code ¤ 1031, Exchange of property held for productive use or investment.*
9 See *Sec. 521(a) of the act, amending Subsection (c) of Code ¤ 2010.*
10 See *Code ¤ 2001(b)(2).*
11 See *Sec. 511(c) of the act, amending Subsection (c) of Code ¤ 2001.*
12 See *Sec. 521(c) of the act, amending Subsection (c) of Code ¤ 2631.*
13 *The amount exempt from gift tax is called the "applicable exclusion amount" under the Code and is the same exclusion that applies at death. The gift and estate tax under prior law were thus "unified". Under the act the exemption for each tax will be different.*
14 See *Sec. 521(b) of the act, amending Subsection (a) of Code ¤ 2505.*
15 See *Code ¤ 2001(b)(2).*
16 See *Sec. 511(d) of the act, amending Subsection (a) of Code ¤ 2502.*
17 See *Sec. 521(b) of the act, amending Subsection (a) of Code ¤ 2502.*
18 See *Sec. 501(a) of the act, adding a new Code ¤ 2210. Termination [of the Estate Tax].;* See *Sec. 501(b) of the act, adding a new Code ¤ 2664. Termination [of the Generation Skipping Transfer Tax].*
19 See *Sec. 541 of the act, amending Code ¤ 1014 and Sec. 541 of the act adding Code ¤ 1022.*

20 See *Sec. 542 of the act, adding Code ¤ 1022(b).*
21 See *Sec. 542 of the act, adding Code ¤ 1022(c).*