Estate Planning With Uncertain Tax law

Presented by:
Joe Chenoweth, CLU, ChFC, AEP
Vice President, Estate & Financial Planning Division

16479 Dallas Parkway, Suite 850
Addison, Texas 75001
(469) 737-4000

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Agenda

• Historical perspective on estate taxes
• Most recent bills / proposals
• Political environment relative to estate taxes
• Planning issues & ideas for 2010
• Future of estate planning
History of Estate Taxes

- **1797**: First Tax
  - **1802**: Repealed
- **1862**: Civil War
  - **1870**: Repealed
- **1898**: Spanish American War
  - **1902**: Repealed
- **1916**: Beginning Modern Era Tax
- **1918**: Charitable Deduction
- **1924**: Top Rate 40%
  - **1926**: Gift Tax Added
    - **1932**: Reintroduced
- **1941**: Rate 77%
- **1948**: Partial Marital Deduction
- **1949**: Top Rate 77%
- **1950**: Tax Reform
- **1951**: Top Rate 70%
- **1954**: Partial Marital Deduction
- **1956**: Top Rate 50%
- **1957**: Partial Marital Deduction
- **1958**: Top Rate 40%
- **1969**: Partial Marital Deduction
- **1976**: Unified System + GST
  - **1981**: Unlimited Marital Deduction
- **1997**: Unified Credit
  - **1999**: Increases QFOB Deduction
- **2001**: EGTRRA

19 major changes (1 every 4.5 yrs.)

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History of Estate Taxes

• 1941-1976 (35 years)
  – Exemption amount = $60,000
  – Top bracket = 77%

• 1977-1987
  – Exemption amount gradually increased to $600,000
  – Top bracket gradually decreased to 55%

• Next 14 years - No changes to exemption amount or top bracket until EGTRRA 2001

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Recent History of Estate Taxes

• EGTRA 2001
  – Applicable Exclusion Amount (AEA) gradually increased to $3,500,000 for estate & GST tax (2009)
  – Top bracket gradually decreased to 45% (2009)
  – No estate or GST tax in 2010
  – 2010 replaced estate & GST with Modified Carryover Basis rules
  – 2011 All the above changes “sunset” and we return to 2001 tax levels
    • $1,000,000 exemption amount for estate, gift & GST
    • Top bracket of 55%

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More Recent History of Estate Taxes

• 12/3/09 H.R. 4154
  – Make permanent $3,500,000 AEA & 45% top bracket
  – Prevent switch from “step-up” to “carryover” basis
  – Vote was 225 – 200 (no Republican votes!)
    • Holding out for higher exemption & lower tax rate
  – Senate did not act

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How Did We Get to This Point?

• It is 2010
  – There is no Federal Estate or Generation Skipping Transfer Tax
  – Those taxes replaced by “Modified Carryover Basis” rules
    • For decedents dying after 12/31/09 the basis of property acquired from a decedent is the lesser of the decedent’s adjusted basis or fair market value
    • Inheritors will be subject to capital gains taxes on any of those assets sold for greater than the carryover basis amount
    • Potentially could reach far more tax payers than the FET or GSTT!

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More Recent History of Estate Taxes

• **6/15/10**, H.R. 5486 Small Business Jobs & Tax Relief Act
• **6/16/10**, H.R. 5297 Small Business Lending Fund Act
• Both being considered by Senate as H.R. 5297
• Propose to “fix” abuses with GRATs
  – Require minimum term of 10 years
  – Require value of remainder interest to be greater than zero
  – Prohibit annuity payments from being “front loaded” for 1st ten years
  – Projected to raise $4.45 billion in incremental tax revenue
• No action in Senate to date

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More Recent History of Estate Taxes

- **July 2010 Lincoln-Kyle Senate Proposal**
  - *Bi-partisan bill by John Kyle (Rep-AZ) & Blanche Lincoln (Dem-AR)*
    - Increase AEA to $5,000,000
    - Lower top bracket to 35%

- Neither Senate Majority Leader, Harry Reid, nor House Speaker, Nancy Pelosi have allowed the bill to come to a vote in either house.
Other Recent Proposals

• Eliminate valuation discounts on intra family transfers of non-controlling, minority interests in FLPs, LLCs and interests in family businesses
Political Environment

• Almost every year since 2001 the House has passed legislation to make permanent the Applicable Exclusion Amount & Maximum tax rate of the EGTRRA 2009 levels ($3,500,000 & 45%)

• However, because of the way the Act was written, it can only be amended by a super majority (60 votes) in the Senate

• Not having the required votes, the Senate has refused to act

• Proving the irrelevance of the House on the subject of wealth transfer tax reform.
Political Environment

Congressional Death Tax Debate

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Political Environment

Congressional Death Tax Debate

Extracts money from those who want to be heard in the discussion.

If Congress resolves the uncertainty – the goose dies!

Will Congress purposefully kill the goose that lays the golden eggs?

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Political Environment

• Obama administration appears unconcerned about the transfer tax situation despite repeated demands for higher taxes on the “rich.”

• Regarding true change to the Bush 2001 & 2003 tax cuts, House Speaker, Nancy Pelosi, has said she will let the Senate take the lead.
Political Environment

• If Congress allows the sunset provisions of EGTRRA 2001 to occur, ALL TAXES
  – Income
  – Capital gains
  – Estate
  – Gift
  – Generation skipping

• will increase on January 1, 2011.

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Political Environment

• Lame Duck Congress convenes 11/15/10
• Biggest job is adjusting to election results:
  – Leadership positions to fill
  – Committee make up & ratios to rebalance
  – New members to orient
  – Agendas for next Congress to work out
  – Unfinished legislation that there is consensus to pass
• And then they break for Christmas

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Political Environment

• There isn’t enough time or motivation
  – To extend any of the EGTRRA 2001 tax cuts
  • Possible exception for extending income tax cuts for individuals who make less than $200,000 (marrieds at less than $250,00)
  – Or to patch the carryover basis issue on estates of decedents who die this year
The Chrystal Ball on Change

• Is change in federal transfer tax law inevitable?
  – Probably

• Change to what?
  – Depends on who won the power this week

  • Republicans: Higher exclusions, lower maximum tax rates, no change in GRATs or discounts for intra family gifts of minority interests

  • Democrats: Exclusions higher than $1 million, maximum rate lower than 50% with “premium rate” for the most wealthy, 10 yr. minimum GRATs, no discounts for intra family gifts of minority interests

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For Clients Who Died in 2010

• Estate Administration issues

• Formula clauses in wills & RLTs
  – *Formerly* good, solid practice … but may wreak havoc on estates of those who die this year
  – Bequests defined in terms of tax concepts when the terms no longer exist in the code
    • “Maximum marital deduction”
    • “Applicable exclusion amount”
    • “GST exemption”

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Formula Clause Examples

• “I give to my spouse the lesser of the maximum marital deduction allowable or the minimum amount necessary to reduce my Federal estate tax to zero.”
  – What is the “lesser of” an amount that doesn’t exist in the code or some other number?
  – What is the “minimum amount necessary” when there is no Federal estate tax?
  – What does he/she get?

• What was original intent?
“I give to Trust B (Credit Shelter trust) an amount equal to the largest amount possible without my estate paying any federal estate taxes.”

- What is the largest amount that won’t produce a Federal estate tax in a year where there is no Federal estate tax?
- All of it?
- What if that trust doesn’t provide an income interest to my surviving spouse?

What was original intent?
Formula Clause Examples

• “I give to Trust C, for the benefit of my grandchildren, an amount equal to the maximum amount that would generate no GST tax.”
  – How much of the estate is that?
  – All of it?
  – What about surviving spouse and children?

• What was the original intent?

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For Clients Who Died in 2010

• Dealing with Modified Carryover Basis
  – Prior to 1/1/10 a decedent’s cost basis in all assets was “stepped up” to the fair market value on the date of death
  – Under Modified Carryover Basis rules the decedent’s basis in each asset is the lesser of the adjusted basis or fair market value.
  – If an asset is worth more than the decedent’s basis the executor can apply a $1,300,000 basis allowance to the difference – asset by asset.
  – If the inheritor is a surviving spouse there is an additional $3,000,000 basis allowance.
For Clients Who Died in 2010

• Dealing with Modified Carryover Basis

• Executors/Inheritors need to take following steps:
  – Have assets appraised
  – Locate purchase records
    • If you can’t prove what it costs, IRS assumes zero.

• Potentially very difficult chore for:
  – Securities transferred between financial institutions
  – Closely held business interests
  – Real property with improvements held for several generations

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For Clients Who Died in 2010

• Dealing with Modified Carryover Basis

• Executors/Inheritors need to take following steps:
  – Delay selling appreciated assets
    • Slim, slim chance that carryover basis ONLY applies to assets inherited AND sold in 2010
      – If true only gain on sale would be increase in value after date of death
    • Better bet:
      – Carryover basis applies to assets inherited in 2010 REGARDLESS of when sold

UNLESS...

Congress repeals the carryover basis rules retroactive to 1/1/10.

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For Clients Who Died in 2010

• Dealing with Modified Carryover Basis

• Executors/Inheritors need to take following steps:
  – Postpone distributions
    • Prerequisite to making distributions is to determine if there is enough cash to pay either a retro-active estate tax or a capital gains tax

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For Clients Who Died in 2010

• **Dealing with Modified Carryover Basis**

• **Executors/Inheritors need to take following steps:**
  – **Extend paperwork deadlines**
    • Law requires reporting of large 2010 transfers with decedent’s final income tax return
      – Deadline is April 15, 2011 or October 15, 2011
    • IRS has not created instructions for or designed a form for this reporting
      – When designed, will probably require executor to list each asset with basis & DOD value
      – Will also need to indicate which assets the $1.3/$3.0 million basis adjustments were applied to
      – Basis adjustments cannot be applied to IRD assets!

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For Clients Still Alive in 2010

• **2010 Planning Ideas**
  • Review all estate plans
    – What impact will death in 2010 have on the plan
    – Formula clauses including pre-2010 tax language may have opposite effect of desired result
  • Consider outright gifts to grandchildren
    – With no GSTT in 2010 gifting down multiple generations more favorable than any other year
      • Good time to use “targeted” assets (FLP, FLLC, non-voting stock in family business)

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For Clients Still Alive in 2010

- **2010 Planning Ideas**
  - Trigger capital gains in 2010 (15%) to avoid taxes at a higher rate later
  - Consider the Roth conversion
    - **2010 only taxpayer at any income level can:**
      - Convert Traditional IRA to Roth IRA
      - Spread income tax liability over 2011 & 2012 tax years
        - Need to have assets other than the IRA from which to pay the taxes
        - Need to be young enough to make up for the tax payment with future investment returns

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For Clients Still Alive in 2010

• **2010 Planning Ideas**

• Consider making taxable gifts in 2010
  
  – This year only, gift tax rate for taxable gifts (in excess of $1,000,000 lifetime exclusion) is only 35%

  • Gift tax is “tax exclusive” meaning the estate is reduced by the gift and the taxes paid

  • Estate tax is “tax inclusive” meaning transferred amounts are reduced by taxes paid
For Clients Still Alive in 2010

- **2010 Planning Ideas**
- Create & fund GRATs
  - Any new transfer tax reform is likely to severely curtail or eliminate short-term, rolling, zeroed-out GRATs
  - Strike now!
- Consider gifts of GRATs, FLP & FLLC interests
  - NOTE: recent Price Case makes it harder for these transfers to qualify for gift tax annual exclusion.
    - Walter M. Price, et ux v. Comm’r, T.C. Memo 2010-2
For Clients Still Alive in 2010

• 2010 Planning Ideas

• Sell assets to “grantor” or “dynasty” trusts
  – Sale doesn’t trigger taxable gift
  – Good way to lock in depressed values before too much of a recovery

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For Clients Still Alive in 2010

• **2010 Planning Ideas**

• Good year for Charitable Planning
  – Phase-out rules of IRC Sec. 68(a) for itemized deductions do not apply in 2010
    • Previously, as a result of the 80% phase-out of itemized deductions, the effect of a charitable deduction was reduced to only 7%
    • But for charitable gifts in 2010 the same client will receive a deduction equivalent of 35%
  – Low interest rate environments make many forms of charitable planning work better
    • Gifts of remainder interests (residence, farm, etc)
      – Value of retained interest follows interest rate, so value of remainder interest increases when interest rates are low

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Future of Estate Planning

• Where is tomorrow’s estate planning work going to come from?
  – The income tax, estate tax and dispositional aspects of the $16 trillion in retirement plans
  – The tax, legal & liability issues surrounding exit & succession planning for owners of closely held businesses
  – The 49% of all US marriages that end in divorce
  – The millions of clients who need to plan for the needs of “special” children
  – The 79 million baby boomers who are moving into retirement and old age

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Future of Estate Planning

• Where is tomorrow’s estate planning work going to come from?
  – Sheer explosion of wealth in the US
    • Most recent estimate is that between $41 & $136 trillion will pass by 2050!
  – All the existing estate plans that will have to be reviewed and/or changed once we know what the newest law change is
  – The multitudes of trusts which need to be funded with income producing assets
  – The billions of life insurance that needs to be in place because of either an estate size or an estate tax problem
  – And the beat goes on …

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Future of Estate Planning

• While the uncertainty of transfer tax law has been good for members of Congress
• It has also been good for those who practice in the estate planning arena
• But the uncertainty has caused too much emphasis to be placed on assets and planning around the transfer taxes

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Future of Estate Planning

• Estate planning doesn’t start with things or the taxes imposed on them
• It starts with people and who they are
• It is about who their families are and might become
• It is about creating financial independence for families
• Then it is about protecting and preserving a positive legacy for the family
• And lastly it is about what happens with their social capital
Client Objectives

1. Financial Independence
2. Family Legacy
3. Social Capital Legacy

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Future of Estate Planning

• When you focus on planning for the client’s personal legacies –
  – Personalities, careers and life style issues of heirs causes more in-depth discussions
  – Add other non-tax issues and the planning usually becomes more complex

• Much of the planning may center around leaving a legacy of relationships rather than a legacy of conflict
  – Creating the mechanisms that minimize conflict requires more work for the planner
A Final Chrystal Ball

• Transfer tax laws will continue to change
  – Special interest groups will continue to pay to be heard

• Regardless of the changes, the future of estate planning as a profession is alive and well
  – Particularly when we focus more on the clients and less on their stuff

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Thank You!

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