Where Do We Go From Here?
Tax Law Update

DBA Probate, Trust & Estate Law Section

Philip M. Lindquist

March 26, 2013

Where Do We Go From Here?
Tax Law Update
DBA Probate, Trust & Estate Law Section
Philip M. Lindquist
March 26, 2013

I. **Tax Law Update.**

A. This talk has traditionally been about developments in the federal transfer tax law, with substantial emphasis on developments in case law, new rulings, new statutes and new regulations.

B. This is not going to be a traditional tax law update. Estate planning has changed in a profound way, and I think we should spend this time focusing on what has happened, what is happening, and what seems likely to happen in the foreseeable future.

II. **A Brief History of the Estate Tax over the Last 40 Years.**

A. Before the Tax Reform Act of 1976:

1. The top marginal estate tax rate was 77%, almost twice today's 40% rate.

2. The Estate Tax Exemption was $60,000.

3. Gift tax rates were only 75% of the estate tax rates, so the top marginal gift tax rate was 57.75%.

4. The Gift Tax Exemption was $30,000.

5. $60,000 in 1976 indexed for inflation would be worth $244,814.76 today, which is a little more than 4 times as much, and less than an average increase of 4% a year.

6. This year's exemption is 21 times more than the inflation-adjusted estate tax exemption we had in 1976.

7. There was no marital deduction for community property.

B. The Tax Reform Act of 1976:

1. Unified the estate and gift tax system;

2. Dropped the top marginal rate to 70%; and

3. Raised the exemption equivalent for both estate and gift tax purposes to $120,667 in 1977, with a phased increase to $175,625 in 1981.

C. The Economic Recovery Tax Act of 1981 ("ERTA"):

1. Top rate phased in to drop from 70% to 50%;

2. Exemption equivalent raised in steps to $600,000 in 1987, which is worth $1,226,228.87 in 2013 – a little more than 2 times as much as the original amount; and

3. Introduced the unlimited marital deduction.

D. The Deficit Reduction Act of 1984 froze the top marginal rate at 55% and deferred the last 5% reduction of the top rate from 1985 to 1988.

E. The Revenue Act of 1987 deferred the last 5% reduction of the top rate from 1988 to 1993, and introduced the 5% clawback on taxable estates in excess of $10 million to recover the benefit of the exemption equivalent and the lower brackets.

F. The Omnibus Budget Reconciliation Act of 1993 cancelled the last 5% reduction of the top rate, freezing it at 55%.

G. The Taxpayer Relief Act of 1997 phased in increases in the $600,000 applicable exclusion amount to what would have been $1 million in 2006.

H. The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act").

1. Phased in increases in what was then the $675,000 exemption equivalent as follows:

   a. 2002–2003: $1 million (which the gift tax did not get past);

   b. 2004–2005: $1.5 million;

   c. 2006–2008: $2 million;

   d. 2009: $3.5 million; and

   e. 2010, which

      i. Repealed estate tax with carryover basis after adjustments,

      ii. Repealed GST tax (later changed to 0% rate for 2010), and

      iii. Imposed gift tax at 35% for lifetime gifts over $1 million.

2. The top estate tax rate dropped from 55% to 50% and the 5% clawback was repealed.

3. The state death tax credit was replaced with a deduction.

4. The 2001 Act sunset at the end of 2010.

I. The Taxpayer Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act").

1. The exemption equivalent was increased to $5 million in 2011, and indexed for inflation.

a. The inflation indexed amount is $5,120,000 for 2012.

b. The inflation indexed amount is $5,250,000 for 2013.

c. Note that the most recent inflation increase of $130,000 is more than what the $30,000 gift tax exemption would be if it was indexed for inflation from 1976.

2. The estate tax and gift tax exemptions equivalents were reunified, which increased the gift tax exemption from the $1 million cap imposed by the 2001 Act.

3. The marginal estate tax rate (and the only rate anyone paid) was 35%.

4. Portability was introduced, allowing surviving spouse to use the deceased spouse's unused exemption if:

i. An election is made on the deceased spouse's estate tax return, even if a return is not otherwise required; and

ii. The surviving spouse does not survive another spouse.

5. The 2001 Act's sunset was extended to the end of 2012, when the 2010 Act also sunset.

J. American Taxpayer Relief Act of 2012 (enacted in 2013).

1. There are only four transfer tax provisions.

a. The marginal estate tax rate (and still the only rate anyone pays) is 40%.

b. The 2001 Act's sunset was repealed.

c. The 2010 Act's sunset was repealed.

d. A technical change, which had already been made by the Treasury Regulations, was made to the portability provisions.

K. Although the 2010 Act provisions have been with us for two years, I find myself thinking about them, and reacting to them, in a very different way now that they

are permanent as opposed to temporary provisions. In fact, this is the first time since 1997 (at the end of the 10-year period of transfer tax stability that began in 1988) that the transfer tax law has not had future changes to be phased in.

III. The History of the Exclusion and the Top Marginal Rate.

Year	Applicable Exclusion Amount	Unified Credit	Top Marginal Rate
1976	$60,000	-	77%
1977	$120,667	$30,000	70%
1978	$134,000	$34,000	70%
1979	$147,333	$38,000	70%
1980	$161,563	$42,500	70%
1981	$175,625	$47,000	70%
1982	$225,000	$62,800	65%
1983	$275,000	$79,300	60%
1984	$325,000	$96,300	55%
1985	$400,000	$121,800	55%
1986	$500,000	$155,800	55%
1987	$600,000	$192,800	55%
1988–1997	$600,000	$192,800	60%/55%
1998	$625,000	$202,050	60%/55%
1999	$650,000	$211,300	60%/55%
2000	$675,000	$220,550	60%/55%
2001	$675,000	$220,500	60%/55%
2002	$1,000,000	$345,800	50%
2003	$1,000,000	$345,800	49%
2004	$1,500,000	$555,800	48%
2005	$1,500,000	$555,800	47%
2006	$2,000,000	$780,800	46%
2007	$2,000,000	$780,800	45%
2008	$2,000,000	$780,800	45%
2009	$3,500,000	$1,455,800	45%
2010	Repeal		0%
2011	$5,000,000	$1,730,800	35%
2012	$5,120,000	$1,772,800	35%
2013	$5,250,000	$2,045,800	40%

IV. Changes in the Transfer Tax Laws Since 1981 Have Changed Our Practice Area.

A. There is much less estate and gift tax work today as compared to the amount of work that existed in 1976.

B. Lawyers who practice at the highest levels of the practice are an aging group.

1. Of the 50 ACTEC Fellows who have their primary listing in the ACTEC Directory as being in Dallas:

    a. 13 graduated from law school more than 50 years ago;

    b. 10 graduated from law school more than 40 years ago, but no more than 50 years ago;

    c. 21 graduated from law school more than 30 years ago, but no more than 40 years ago;

    d. 3 graduated from law school more than 20 years ago, but no more than 30 years ago; and

    e. 3 graduated from law school more than 10 years ago, but no more than 20 years ago.

2. ERTA, which passed on August 13, 1981, gave us the unlimited marital deduction, raised the exclusion amount to $600,000 and dropped the top marginal rate from 70% to 50% (which later was raised back to 55%).

3. In the mid-80's, I was a young associate at what was then the second largest law firm in the country, and was told that no one would make partner in the future at that firm whose only practice area was our practice area.

C. Estate planners have moved out of big firms to boutique and solo practices.

D. Strong practitioners have moved into expert advisor roles for corporate trustees as a part of the corporate trustee's business development.

E. Less and less estate planning work is transfer tax sensitive and is much less tax driven. When I was a solo practitioner in Plano, many of my clients were not worried about estate taxes, but I could get them to use trusts for asset protection and asset management.

V. <u>What the Current Transfer Tax Laws Mean for Estate Planning in the Future</u>.

A. The above trends will continue with even more strength, as many fewer estate plans will be tax driven than was the case even a few years ago.

B. Transfer tax planning is no longer at the center of the estate planning universe.

1. Consider this letter from the President of ACTEC to its Fellows:

McPherson Building
901 15th Street, NW, Suite 525
Washington, DC 20005
(202) 684-8460 Fax (202) 684-8459
www.actec.org

THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

BOARD OF REGENTS

President
LOUIS A. MEZZULLO
Rancho Santa Fe, California

President-Elect
DUNCAN E. OSBORNE
Austin, Texas

Vice President
KATHLEEN R. SHERBY
St. Louis, Missouri

Treasurer
BRUCE STONE
Coral Gables, Florida

Secretary
CYNDA C. OTTAWAY
Oklahoma City, Oklahoma

Immediate Past President
MARY F. RADFORD
Atlanta, Georgia

STEPHEN R. AKERS
Dallas, Texas
GLEN S. BAGBY
Lexington, Kentucky
SUSAN T. BART
Chicago, Illinois
TURNEY P. BERRY
Louisville, Kentucky
MARC A. CHORNEY
Denver, Colorado
MARK M. CHRISTOPHER
Boston, Massachusetts
MARY JANE CONNELL
Honolulu, Hawaii
M. PATRICIA CULLER
Cleveland, Ohio
C. FRED DANIELS
Birmingham, Alabama
P. DANIEL DONOHUE
Sioux Falls, South Dakota
NANCY G. FAX
Bethesda, Maryland
SUSAN N. GARY
Eugene, Oregon
J. KEITH GEORGE
Los Osos, California
ROBERT W. GOLDMAN
Naples, Florida
T. RANDALL GROVE
Vancouver, Washington
LOUIS S. HARRISON
Chicago, Illinois
PAUL C. HEINTZ
Philadelphia, Pennsylvania
ROBERT K. KIRKLAND
Liberty, Missouri
JAMES M. MADDOX
Hobbs, New Mexico
MARY ANN MANCINI
Washington, District of Columbia
KEVIN D. MILLARD
Denver, Colorado
R. HAL MOORMAN
Brenham, Texas
CHARLES IAN NASH
Melbourne, Florida
ANNE J. O'BRIEN
Washington, District of Columbia
DAVID PRATT
Boca Raton, Florida
CHARLES A. REDD
St. Louis, Missouri
CHRISTY EVE REID
Charlotte, North Carolina
ANNE-MARIE RHODES
Chicago, Illinois
ANITA J. SIEGEL
Morristown, New Jersey
DEBORAH J. TEDFORD
Mystic, Connecticut
JOHN A. TERRILL II
West Conshohocken, Pennsylvania
HOWARD S. TUTHILL III
Greenwich, Connecticut
DIANA S.C. ZEYDEL
Miami, Florida

Please Address Reply to:

Executive Director
DEBORAH O. MCKINNON

January 9, 2013

Dear Fellows,

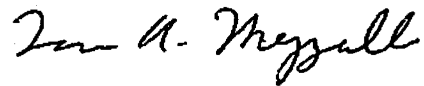
By now you are all aware that President Obama has signed the American Taxpayer Relief Act of 2012. Among other items, it makes permanent the $5 million indexed applicable exclusion amount for gift and estate tax taxes and the $5 million indexed exemption for the generation-skipping transfer tax. While many may feel that this will reduce the amount of work we do as estate planners, I have the following comments. First, nothing is permanent as long as Congress meets once a year. Second, as I have said before, there are many things we do for our clients that will not be affected by the higher exclusions and exemption. The following is a list, not meant to be exhaustive, of some of those items:

1. Planning for the disposition of the client's assets at his or her death.
2. Asset protection planning.
3. Planning for disability and incompetency.
4. Business succession planning (without the estate tax to blame for failure of a business).
5. Planning for marital and other dissolutions.
6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).
7. Life insurance planning (other than to provide funds to pay taxes).
8. Fiduciary litigation (enhanced because more to fight over).
9. Retirement planning.
10. Planning to pay state death taxes (in many states).
11. Planning to avoid or minimize gift taxes (when client desires to gift more than the $5 million indexed applicable exclusion amount for gift tax purposes)
12. Using business entities to accomplish nontax objectives.
13. Planning for children with disabilities.
14. Planning for spendthrift children.
15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).
16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.
17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.
18. Planning for citizens who intend to change their citizenship.
19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.
20. Planning to pay education expenses, including contributing to I.R.C. § 529 plans.
21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPAA, and charitable governance reform.
22. Identifying guardians for minor children, if and when needed.

A major goal of the College going forward will be to continue to provide quality professional programs on all of these matters that are as important if not more important for our clients than saving transfer taxes.

My wishes for a Happy, Healthy, and Wealthy New Year.

I hope to see you in Maui.



President

2. It is harder for clients to recognize value without tax savings.

3. This is a profound change in our practice and in our professional associations.

a. How many of you today care about the IRS's ruling position on reciprocal special powers of appointment giving rise to general powers of appointment?

b. Should the Dallas Bar form a Transfer Tax Section for the diminishing few who will truly be concerned about these issues in the future?

c. How many of their meetings should the Dallas Estate Planning Council and the Estate Planning Council of North Texas devote to transfer tax issues in the future?

C. Trade-offs between transfer tax savings at the price of higher income taxes will be closer calls, if they are close calls at all. Once they have taxable income over $11,950, trusts and estates are in the 39.6% income tax bracket, plus the 3.8% Medicare tax on passive and investment income. Compare to a 40% transfer tax, if any transfer tax is due at all.

1. With these relative tax rates, and very low discount rates, *Graegin* loans are not the "no brainer" they used to be.

2. The discounting of entity interests versus new undiscounted basis at death also merits closer consideration.

3. We will also want to consider the trade-off of carryover basis of gifts versus new basis at death.

D. The government will be paying part of your fees for estate administration in many fewer estates, and even when it does, it will be paying 40% rather than as much as 50%, 55% or even 60%.

E. Will we seek to reform more trusts to deal with a very different transfer tax environment?

1. Many trusts have provisions shaped by transfer tax provisions that were much less generous than current law.

2. How many of these trusts will be reformed, and how?

F. Planning for assets subject to state death taxes will be more difficult.

1. In many states, the state tax is now relatively large compared to the estate tax.

2. State taxes often present difficult trade-offs at the death of the first spouse.

G. Implications for the Administration of Transfer Taxes.

1. Will we see more gift tax audits like we are seeing for 2010?

2. Where will the Internal Revenue Service get the estate and gift tax attorneys they will need to administer the transfer taxes?

VI. What Will Transfer Tax Sensitive Estate Planning Look Like in the Future?

A. Portability means even fewer tax-driven wills for couples that have more than $5 million.

B. Of the estate plans that have transfer tax planning in them at all, many more will be "all to my spouse" with the option of disclaiming into a bypass trust.

C. More gifts will be simple outright gifts, without transfer tax driven trusts or other transfer tax driven arrangements.

D. Non-married couple planning will be less transfer tax limited.

E. GST exempt gifts will be easier, and often less valuable.

F. Additional tax-free gifts can be made every year after the client has exhausted the available gift tax exemption in the prior year.

G. Leveraged gifts will be much more powerful because there is more gift tax exemption to leverage.

1. Life insurance trusts.

2. Gifts to grantor trusts.

3. Gifts and sales to grantor trusts.

4. And another sale to a grantor trust after the assets appreciate.

5. GRATs may be less common.

a. Primary advantage is they are self-adjusting.

b. May be the vehicle of choice with volatile assets and hard to value assets.

c. Expect a minimum 10-year term in a future legislative change.

6. QPRTs may be less common.

H. Looking out in the long-term future, will enough people be subject to the transfer tax to support the sophisticated practitioners that are required to administer it?

1. Will the Internal Revenue Service commit enough resources to auditing gift tax returns when there is no gift tax to collect to encourage compliance with the laws requiring the timely reporting of all taxable gifts?

2. Will there be enough people in the practice of law who understand the transfer taxes for there to be a reasonable level of compliance?

3. Will the current transfer tax system be replaced by a different system, such as making gifts and inheritances taxable income, with exemptions to taxable income being permitted up to a specified amount per donor?

a. Is there much difference between paying estate tax at 40% and paying a 39.6% income tax on the inheritance?

b. How would the various retained interests that are taxed under current law be handled?

VII. **Portability.**

A. Advantages.

1. Do not need to plan for tax advantage of portability, so, at a minimum, it is "first aid" for the estate that has no tax planning but may need it.

2. Appreciated assets take a new basis at the death of the surviving spouse.

3. Portability may be an easier way to deal with retirement assets that would otherwise be needed to fund a bypass trust.

a. At the least, it is just easier.

b. May consider paying the income tax on the assets with pre-estate tax money, but the trade-off would be loss of deferral otherwise available to beneficiaries of retirement assets.

4. Portability may be more advantageous after considering income taxes, particularly in situations where the combined estate tax exemptions exceed the combined assets at the first death, leaving some estate tax exemption available to cover future appreciation, which can be erased for income tax purposes by taking a new basis when the assets are included in the surviving spouse's estate.

5. Portability may be an easier way to deal with state death tax issues.

B. Disadvantages.

1. Have to file estate tax return to preserve deceased spouse's exemption even when a return is not otherwise required, which is not an inconsequential expense.

2. Deceased spouse's unused exemption is lost if the surviving spouse survives a subsequent spouse.

   a. Is this a risk that you can insure with life insurance?

   b. Does the age of the client make a difference in how you evaluate the risk of this?

   c. Does the sex of the client make a difference in how you evaluate the risk of this?

3. Deceased spouse's unused exemption amount is fixed and may not cover the value of appreciated assets.

4. Portability does not preserve the deceased spouse's unused generation-skipping transfer tax exemption.

5. Assets not held in trust can be disposed of by the surviving spouse in ways the deceased spouse would not have, possibly disinheriting some of the deceased spouse's expected takers on the second death.

6. Assets not held in trust do not get spendthrift protection.

C. Best planning may not be bypass trust planning or portability, but QTIP trust planning with portability.

D. How much is it worth to preserve the deceased spouse's unused exemption?

1. Do you need to worry that your client might win the lottery?

2. How much effort should you put into discussing the issue with your client and papering your file?

E. Consider the following issues to address in your practice regarding portability:

1. A question to ask new clients: "Did you have a spouse who died on or after January 1, 2011? If so, please provide us with a copy of your deceased spouse's federal estate tax return."

2. Address portability in your documents, including who will bear the cost of an estate tax return filed only to preserve the deceased spouse's unused exemption.

3. Provide means in a bypass trust to cause it to be taxed in the surviving spouse's estate, such as giving an independent trustee or trust consultant the power to distribute assets to the surviving spouse apart from an ascertainable standard or to give the surviving spouse a general power of appointment.

4. Consider restructuring estate plans to use portability to optimize combined tax savings.

F. Revenue Procedure 2001-38 is a potential obstacle to portability planning with a marital trust. The Internal Revenue Service is being asked to review this situation.