Unintended Consequences

By Gregory C. Hamilton and James T. Blazek

Congress in 2001 enacted the Economic Growth and Tax Reconciliation Relief Act (EGTRRA), which among other things, phased in lower estate tax rates and higher exemptions through 2009, but provided for a one-year sunset of the estate tax for decedents dying in 2010, with a reinstatement of the estate tax in 2011 and thereafter. While it was widely expected that Congress would amend the law to avoid the estate tax sunset before it became effective, to date this has not happened. Gregory C. Hamilton and James T. Blazek identify the unintended consequences of Congress' failure to act, and discuss several traps for the unwary that can be avoided by diligent planning and plan implementation.

Gregory C. Hamilton received a B.S. in Microbiology from Michigan State University, a Masters of Science in Occupational and Environmental Health from Wayne State University and a J.D. Cum Laude from Detroit College of Law. He is currently a member of the National Network of Estate Planning Attorneys, Financial Advisory and Estate Planning Counsel of SE Michigan, and National Association of Christian Financial Consultants. Greg was a contributing author to the book Love, Money and Control. Greg has authored Allied Professional Newsletters and various other articles. He is a lecturer for several professional organizations across the country and was awarded 2010 Five Star Wealth Manager in HOUR Magazine, June 2010 edition, being voted by clients as one of the top estate planning attorneys. Greg can be reached by e-mail at *ghamiltonesq@aol.com.*

James T. Blazek received his J.D. from Creighton University School of Law in 1981. Jim has been bringing peace of mind to his clients through effective and personalized estate planning for more than 28 years. He is dedicated to the advancement of attorneys, CPAs, insurance professionals and financial planners through education. Jim has authored Estate and Tax Planning for Qualified Retirement Plans and IRAs in Nebraska (2002), Limited Partnerships and Limited Liability Companies (1999), How to Draft Wills and Trusts in Nebraska (1996), Elder Law: Taking Control (1995) and How to Draft Wills and Trusts in Nebraska (1994). Jim is a contributing author to the books Giving Philanthropy for Everyone (2003) and Generations: Planning your Legacy (1999). Jim can reached by e-mail at *jim@blazeklaw.com.*

Introduction

As so often happens, our actions can lead to unplanned and unexpected courses. This is what has happened when the vaunted federal estate tax was repealed for 2010. It has the potential to create havoc for the unwary. This article is intended to help navigate through these uncertain times. If we are aware of the potential traps, we can counsel our clients about them and hopefully draft around them, keeping the hazards to a minimum. At the very least, what Congress has done with its inaction on this issue is give us all a golden opportunity to meet with our clients and deepen the relationship we have with them. We need to pay special attention to the opening that Congress has afforded us. We can now draft documents for new clients to help protect them and we also have an occasion to revisit old clients and bring their estate plans more in line with what the rules are today and hopefully into the coming years. It has been said that the average estate plan is updated every 19.6 years. If we as planning professionals let

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this become reality for our clients, they may face an unpleasant tax consequences along with results that are nowhere near what they intended. Who will the heirs call at that time? Is that a conversation you want to have with them? It's always best to be proactive. This article is intended to help make you aware of some of the issues that are of the utmost importance to your clients and supply you with talking points for the discussions you will want to have with them.

How did we ever get to this point of mass confusion? Most estate planners and tax authorities never dreamed Congress would let the federal estate tax lapse. After all, they had 10 years to plan for it. The Economic Growth and Tax Reconciliation Relief Act (EGTRRA) was passed 10 years ago. Everyone was planning that Congress would not allow for the federal estate tax to lapse for one year. Everyone was wrong.

The improbable has happened. The federal estate tax has been repealed for one year. That's right, only for 2010. Under current law, in 2011 it returns with a vengeance. Given the uncertainty Congress has created in the law there are questions for the living clients and also for those who have passed away. For those yet living the question is how to draft new plans or amend the existing plans to appropriately deal with the 2010 repeal. For those who have passed away in 2010 the question becomes when and how to distribute the assets, pay any taxes and create the post mortem trusts.

Failure to address these and other issues may result in an uncomfortable call to your errors and omissions carrier. Our goal is to give you some information to address some of these points to steer you clear of the pot holes.

Background

Before we begin this journey to address the issues Congress has presented to us, we need to know some history of the federal estate tax or more commonly referred to as "the death tax."

Those who think there will be no federal estate tax in 2011 and beyond must look at history. History is always a good teacher. The first federal estate tax was put into place shortly after the Revolutionary War. It was repealed. The next phase came to fund the Civil War and that law was also repealed. The third federal estate tax came to help defray the cost of the Spanish American War. It was cancelled. The fourth federal estate tax came about as a result of the deficit created by World War I. In a revised form, it is still with us today. After that tax was created, Congress added the gift tax. This, you will recall, was to prevent the families with assets from giving them away during their lifetime in order to avoid having to pay a death tax.

If Congress continues to stall on the reenactment of the federal estate tax, the federal exemption will return to the 2002 and 2003 levels. Remember in 2009 the federal exemption equivalent amount was $3.5M. The exclusion amount that is currently scheduled to take effect for all those that die starting at 12:01 A.M., January 1, 2011 is $1M. If that is not enough of a burden, the percentage of the tax on any amount over that will be 55 percent.

In 2010, there is no generation skipping tax (GST). So should we all advise our clients to establish a dynasty trust and fund it in 2010? Some in Congress have put forth the proposition of enacting legislation to make the return of the federal estate tax retroactive to January 1, 2010. This means that the federal estate tax and the GST would apply to all trusts and deaths back to January 1, 2010. That would be a problem, if a dynasty trust had been created and funded. Some have held that it would be unconstitutional to do so. Do you want to be the test case? No one knows for certain what the answer is on this point. If you do create a dynasty trust you might consider a "call back" feature to undo the trust if retroactivity becomes reality. Possibly you could create the trust and not fund it until very late in 2010 when it would be almost unfathomable that any federal estate tax would be made retroactive to January 1, 2010.

With this history in place let us review some of the potential traps planning in the environment Congress has created for us.

Trap #1: Unintended Disinheritance

Most revocable living trusts for married couples use a formula to allocate trust assets between a Marital Trust and a Family Trust. The funding formula is verbiage in the document that deals specifically with tax issues. Married couples who either had a taxable estate or expected to have a taxable estate wanted to make sure that the first spouse passing away would use all or at least part of their available exclusion amount for federal estate taxes. On the death of the trustmaker (also known as the grantor, or settlor), the funding formula would direct how the trust assets were divided between a trust that would

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qualify for the marital deduction, usually called the "Marital Trust" and a trust that would qualify for the trustmaker's available exclusion amount, usually called the "Family Trust" or "Credit Shelter Trust" or the "B" trust. The goal of the funding formula is to correctly allocate the trust assets between these two trusts. The more common funding formulas were expressed either in terms of a specific pecuniary amount of assets or as a fractional formula.

The funding formula was drafted to achieve the result of a nontaxable estate on the death of the first spouse to pass away. It would direct the allocation of trust assets so as to first fund either the Marital Trust or the Family Trust and then the other depending on the formula used. For example, the funding formula might direct that all trust assets pass to the Marital Trust except those assets necessary to use the decedent's available exemption amount for federal estate tax, which would then pass to the Family Trust. Another example is the formula that first directs payment of trust assets to the Family Trust in an amount sufficient to use the decedent's available exemption for federal estate taxes with the excess being paid to the Marital Trust. One solves for the Marital Trust first and one solves for the Family Trust first. Over the years we have all reviewed trusts that contained variations of each of these examples. These formulas may work effectively when estate tax is in effect, however they can lead to unintended consequences when there is no estate tax. These clauses were drafted without considering the possibility that there would be no estate tax in effect. Failure to update these funding formulas could leave either the Marital Trust without any assets or the Family Trust without any assets. They may be successful in not incurring an estate tax, but they may be disastrous for one or more beneficiaries. These funding formulas were used for married couples and are not applicable for unmarried clients.

Be careful not to have an unintentional disinheritance of the surviving spouse, children or charity. The greatest mischief can be caused in situations where a surviving spouse is a beneficiary under one trust but not the other. Generally in first marriages, this is not an issue because the surviving spouse is typically a beneficiary of both the Marital Trust and the Family Trust. The planner should be on guard for those plans where this is not the case and be able to counsel the clients of the possible results. The planner should also be on guard for situations where a spouse may be a beneficiary of both trusts but not have effective control over the trust. Planners usually see more variety in those situations where the client's goals call for a different treatment of the surviving spouse in the different trusts, such as with second marriage situations. These clients would commonly direct that a surviving spouse be treated differently under the Marital Trust, than the Family Trust. For some clients the primary goal is to provide for a surviving spouse and the trusts are drafted to achieve this goal. For other families, the primary goal is to transfer assets to biological children and caring for a second spouse takes a subordinate position. The planner must be able to not only tell the clients what the documents say, but what they really mean in terms of providing for a spouse and other beneficiaries.

In second marriage planning most clients will wish to provide for both their new spouse and their biological children. In many of these cases the Family Trust is drafted to provide for the biological children, and the marital trust is used to support the surviving spouse or the step parent (often referred to as the "evil step parent" after the biological parent dies). When there is no federal estate tax in effect when the trustmaker, dies, either the Marital Trust could be dry or the Family Trust could be dry. Without having assets in the Marital Trust, the surviving spouse may be effectively disinherited although this was not the intention of the decedent. Yet it can lead to horrible results. When the children learn of this, they may not be willing to provide for their step parent. In fact, they may be precluded from providing assets to the spouse without incurring gift tax themselves. The surviving spouse, who may have been a spouse for decades, may be in a situation with no visible means of financial support. Depending on whether or not a premarital agreement was signed there may be elective share issues as well. In situations where each spouse has his or her own revocable living trust, these trusts may be funded unequally or not at all. If the spouse that dies first holds most of the assets there may be a problem. You should be vigilant to monitor the funding of the trusts to ensure that unpleasant situations are avoided, if possible.

Therefore, careful counseling and drafting is required to prevent this from occurring. If there is no change by Congress, then in 2011, the biological children could be "limited" to only one million dollars until their step parent passes away. In fact, if the surviving spouses trust is not carefully drafted all the assets in that trust could go outside the bloodline up the second spouse's death. That generally is not what the trustmaker intended.

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Trap #2: Unplanned Penalties/ Carryover Basis

Prior to January 1, 2010, and after December 31, 2010, there is a "step up in basis" for the fair market value of an asset at the time of death for people inheriting assets. This means that whatever the value of the property is at the time of death, determines the value of the property when it is sold by the next owner. During 2010 Congress has reverted to a law they tried and failed miserably at a few decades ago: Carryover basis, which provides for no step up in basis. This experiment by Congress was, and is, untenable. Why? How many clients actually keep accurate records for one or two years, let alone for 40 or 50 years, and manage them so that a "stranger" to the records can use them effectively?

Under the carryover basis rules, it is on the taxpayer to prove the basis. This will cause many more tax returns to be filed. The tax that will be due will be a capital gains tax. We have been led to believe that percentage on capital gains will be taxed at a significantly higher rate in 2011 and beyond, into the near future at least. The capital gains tax will affect the lower socio-economic classes more than the estate tax, which hit, with its higher rates only those with significant assets. There is a potential that this tax will generate more revenue than did the federal estate tax. Under the federal estate tax if an heir sold the property shortly after death, there would be no gain and therefore no tax due, as a result of the step up in basis. Under the new tax plan, good luck proving the basis if the records are lost, destroyed, inaccurate, illegible or incomplete. This means that many, many more tax returns will be filed with a capital gain. Be it on the fiduciary tax return, the IRS Form 1041, or on the person inheriting the assets on his or her individual income tax return, IRS Form 1040. There were relatively few federal estate tax returns filed compared to the number of deaths. Now, the potential is there that every death will generate a tax form, all due to the carry over basis rule and the imposition of capital gains. Be sure to warn your clients to be watchful for this as they may not utilize the services of a CPA who would inform them of the tax due.

Another unplanned consequence is the prudent investor rule. Under that provision, there is a clear duty to diversify the investments. What this means is that the successor fiduciary will have to sell assets to keep from potential liability for failure to diversify the assets. That raises the potential for unplanned capital gains taxes that would otherwise not be an issue. That tax would not have arisen under the step up in basis as the assets when sold in all likelihood would not have generated any capital gains.

One resolution to that issue is not to sell the assets until 2011. The later the fiduciary gains control of the assets in 2010, the better this strategy will work. If the fiduciary does not diversify and there is a significant downturn in the value of the assets, the fiduciary might be personally liable for any loss of value of the trust assets. What is more important? To pay a capital gains tax and relieve the fiduciary of personal liability or not to pay the capital gains tax and have the fiduciary potentially personally liable for the loss in value of the decedent's assets. You should counsel all fiduciaries about this potential trap before they accept the position. It may make them reconsider their accepting the position. If you act as a fiduciary, be cognizant of this issue. It is best to have a counseling session with the asset holder during lifetime to put in at least the statement of intent what was intended to happen. If that is not possible, have a counseling session with all the heirs to diffuse this ticking time bomb. Whatever the decision is made, ensure that everyone signs off on the course of action taken.

Another point to remember is that nonspouses are allowed $1.3M of step up in basis. This does not mean $1.3M in value. That is a critical distinction. It is $1.3M of appreciation that can be stepped up in basis regardless of the value of the assets. Again, the deceased has to have kept very accurate and detailed records. The actual value of the assets could be substantially more than $1.3M.

Be sure to use the $1.3M/$3M step up in basis and not use the $1.3M total value of the assets. The same holds true for the surviving spouse. The surviving spouse is granted an additional $3M of step up in basis. The fiduciary needs to pay very strict attention to how these assets are funded in order to qualify for this additional $3M of step up in basis. Again, it is $3M of appreciation that can be stepped up in basis, not $3M in total assets. The total amount of the assets could be significantly greater.

It is of the utmost importance to maximize the tax savings in funding the Marital and Family Trusts. The funding must adhere to the estate planning guidelines that hopefully were articulately stated so the longer term goals, aspirations and desires of the deceased can be met. What good is it to save on taxes only to defeat the intent of the decedent? This is why it is always a very good idea to be sure to include a state-

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ment of intent into the estate planning documents. This will be the guide for the fiduciary that is charged with administering the document.

With the funding formula that we already discussed, if all the assets are transferred into the family trust, then the $3M step up in basis that is available to the surviving spouse is forever lost. Is that a good result? Will that expose the fiduciary to potential liability? That will only be determined by the results of a family meeting and with a consensus of the heirs.

Another potential trap is if the marital trust has a general power of appointment, then the $3M step up in basis is not available and is forever lost.

How does one draft for this scenario? It can only be done after thorough counseling with the client. What is more important to the client: saving taxes, taking care of the surviving spouse, taking care of the surviving children or taking care of those with special needs? What about meeting the needs of an ongoing business or carrying out philanthropic desires? All these need to be considered in the documents that are being prepared this year as well as all those prepared before 2010. Now would be a good time to send a letter to the clients that you prepared documents for before 2010 to review them to ensure if they happen to die in 2010, their estate planning goals, aspirations and desires will be fulfilled and you will not have to deal with angry family members.

One method that some estate planners are using to accomplish the desired funding is with the use of disclaimers. If that's the only course that is available in meeting your client's goals, then travel down that road. A better option to avoid the pitfalls associated with disclaimers is through artfully drafted documents and specific funding instructions. Either course should be reviewed with the client while they are able to understand the options.

Under the sunset provision of EGTTRA, the generation-skipping transfer (GST) tax was also repealed for one year. This tax was imposed to prevent the passing of assets to members of a "skip" generation without the government receiving its "fair share."

The question becomes, do you counsel your clients to make dynasty trusts during 2010 that have generation skipping provisions included in them? The trap for the unwary is that there is talk in Congress to reinstate the federal estate tax, along with the generation-skipping transfer tax and make it retroactive to January 1, 2010. This might even be at the 2009 levels, just temporarily. There are some who are of the opinion that this would be unconstitutional. There are others who say that it has been done before. If you suggest to your clients to do a generation-skipping trust and fund it, then Congress follows through with its suggestions, you may have a very unhappy client that owes taxes, when you had informed them there would not be any. One suggestion is to create the trust and hold off funding it until late into 2010, when it may become apparent that Congress will not indeed make any tax retroactive.

The problem is, Congress has already spent the money they have not collected, and they need to get it from everywhere possible. Another suggestion is to create a generation-skipping trust and put in a provision to cancel it if the GST tax comes back to life in 2010. It is unknown whether this technique will work. One way to make it safer would be to loan the money to the trust. Even that method is uncertain to work, but it is available, especially if you have already created and started funding the trust in 2010.

Whatever course is taken in order to qualify for the step up in basis one should ensure that any required IRS Form to allocate the basis increase under the carryover basis rules is filed. It is the taxpayer's duty to allocate this basis increase. If the required form is not filed, then the step up in basis is lost. Before any returns are filed, just ask your client if he or she has allocated the basis increase and be prudent and review what the client has done, before the return is filed. Consider the benefits of contacting the client's CPA. Note: While Code Sec. 6018 imposes penalties on fiduciaries who fail to met EGTRRA carryover basis reporting requirements, as of this writing the IRS has not issued guidance, or a form on which to comply with these requirements.

Remember that the step up in basis is not available for all assets. Assets that are deemed to have been a gift within three years of death are not eligible. Other assets that are not eligible are those that are deemed to be income with respect to a decedent. Those include IRAs, qualified plans and deferred compensation assets.

Trap #3: Charitable Giving

What is one of the driving forces for individuals to include charitable giving in their estate planning documents? Many times it is driven by tax issues. Again, many of the estate planning documents that direct assets to a charity or charities are triggered by some type of a funding formula. They may direct assets to the Family Trust up to, but not exceeding, the

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limit that would result in a zero federal estate tax, or some variation thereof, such as: "Any amount over the amount which would impose a federal estate tax on my assets shall be funded into my private foundation or to XYZ charity."

Well, in 2010, there is no federal estate tax. This means that nothing will be funded into the private foundation or the charity or charities. Was this the desire of the Trustmaker? Probably not. Was this the intended consequence of the repeal of the federal estate tax? Probably not. In order to avoid this outcome, one must artfully draft the documents. Be sure to counsel with your clients to avoid this, if their intent was to ensure that the private foundation or the charity or charities received some amount of their assets.

How did we ever get to this point of mass confusion? Most estate planners and tax authorities never dreamed that Congress would let the federal estate tax lapse.

Avoid the private foundation or charity from being unintentionally left out of the distribution of the assets. It would be a good idea to review the documents that you have drafted that contain charitable giving to avoid any unplanned results. This can be avoided by giving a specific amount to the private foundation or charity first, or state any amount over a sum certain will go to the private foundation or charity.

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Trap #4: Business Succession

One feature of the EGTRRA passed in 2001 had a major effect on business succession planning. It had this effect on two fronts. One was through the death tax imposed by the states themselves. States used to qualify for a pick up tax on the federal estate tax return. This was phased out. To compensate for this loss of revenue many states have enacted their own estate or inheritance tax separate from the federal estate tax. This has created many opportunities for the estate and business planning counseling attorney.

One of those opportunities stems from the decision to pass a family owned business at death or during the business owner's lifetime. A lifetime transfer of the business could help in the transition to new ownership. This is by the retiring member being available to solicit advice from, or to troubleshoot if problems arise. Sometimes this help is welcomed; other times it is not. Sometimes this help is offered when it is not requested. The new owners (generally of a younger generation) have vastly different ideas on how to run the business, market the business and keep records. The retiring generation is not always enthusiastic to embrace these newer methods. The old ways worked "just fine" for them. Why is it that the retiring generation is reluctant to give up the reins of the business in the first place?

It has to do with the attitude that no one—and they do mean no one—is better at running the business than the retiring generation that has run it for the last several decades. The retiring business owner and his or her spouse are also leery of running out of money. What if the "newbies" were not trained well enough to run the business, or they are not good business managers and the business fails? The retiring owners will lose their annuity as well as watch the demise of something as dear to them as one of their children. That is asking quite a bit from the persons letting go, when they are used to being the decision makers who are totally in charge. Granted, there are plenty of times where the new ideas just might save the business in this changing business environment, but that is not visible to the business owner who spent his or her time, sweat and energy to make the business into the company it is today.

Now add into that emotional turmoil the fact that there is no federal estate tax. If there is a death in 2010, a family business could be transferred without the burden of that tax. Remember, however, that there is a capital gains tax to be paid, if the business is ever sold. That includes selling shares or interests to a new shareholder or member. Who is responsible for paying that tax, which could be a substantial amount of money? Is it the business, the residue of the estate or some other source of funding?

Be sure to determine whether passing the business during lifetime or after death fits the client's needs. Did the retiring member keep good and accurate records? How will the records that are lacking be brought up to date? This can be especially onerous after the business owner has passed away. For that reason a lifetime gift may appear on the surface to be the best course to follow.

But what about using the lifetime gift tax exemption of $1M? If the business owner gifts the company away during his or her lifetime there are

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some other issues to consider. If the business is over the $1M amount, won't the remaining children (or those that would inherit) be penalized, especially if the death occurs after December 31, 2010? How will the disparity be made up? In several cases the lifetime transfer has been voted out by the younger buyers especially if they are some of and not all of the children of the owner are to take over the business.

It is not the usual case where all the children decide to continue the business after the current owner steps down through death, disability, or voluntarily resigning, or any combination of the above. When that occurs the estate planner must keep in mind the additional counseling issues that will face the family. One such issue is who will be in control? Who will perform what duties, how often, if ever, will the duties be rotated? How will the children not involved in the business receive their fair share? What are the goals, aspirations and desires of the client? These are not questions clients often like to think about. Generally they just say my kids are different and there will not be any problems. Those are the cases that need the most attention to detail in the transition.

There is still the issue of state death taxes to be concerned with. If your client happens to live in one of the states that has enacted a separate death tax, even with no federal estate tax, the inheritors may face a tax liability. Who is liable to pay that tax? Is it the business, the children that took over the business or the residue of the estate? Your documents must address these issues or there is the potential to be some heated and interesting family discussions.

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Another query that will arise is whether a business appraisal should be completed even when there is no estate tax. This is often fought against due to the cost. Many times the cost is more than justified by the benefits that can be received. Even without an estate tax, there can be a substantial cost basis adjustment that is greatly beneficial. Again, depending on the recipient, either $1.3M of appreciation can be stepped up or $3M of appreciation can be stepped up, or a combination of both. Remember that formula clauses can be drafted to allocate assets to the Marital and Family Trusts based on income tax considerations as well as estate tax considerations. Even without the consideration of basis issues to minimize capital gains taxes, how would the estate be valued and distributed among the surviving beneficiaries if they are to receive either a specific value or a percentage of the trust assets? Without the business appraisal there is an invitation for family fighting as to what the value of the business actually is versus what share was actually received. One of the reasons to do estate planning is to minimize the headaches following death and to try to prevent family fighting. The only way to prevent this is to pay upfront for the business appraisal.

Trap #5: Effect on Gifting

The issue of lifetime transfers versus transfers at death carries over to gifting. If the estate is large enough to encourage substantial lifetime gifting (over $1M) thereby creating a tax liability, the fact that there is no estate tax for decedents dying in 2010 discourages the lifetime shifting of the assets to younger generations in that year. Remember, though, the added layer of counseling that is required due to the loss of the step up in basis. With lifetime gifting there is always the carry over basis issue, as the step up in basis is not available. One exception to this might be to "skip" persons with the generation-skipping transfers. We have already outlined some of the perils involved with that in 2010.

Is it better to gift during lifetime or to transfer after death? In 2010, the lifetime gift tax exemption remained at $1M. Even though there is no federal estate tax, there is still a Federal Gift Tax for any amounts that exceed the $1M. One bright spot related to this is that the tax rate has been lowered to 35 percent, for 2010 only. After 2010, the maximum tax rate is increased to 55 percent. It becomes a counseling issue with the client as to which direction to go, gifting in 2010 or reallocation of title after death in 2011 or after, for accomplishing their estate planning goals, aspirations and desires. Does it make more sense for your wealthier clients to pay the 35 percent (which is tax-exclusive), so the person receiving the gift actually receives the amount given and thereby potentially decreasing the federal estate tax liability) or to pay up to a 55 percent federal estate tax, as it is scheduled to go to in 2011. Consider the fact that the federal estate tax is tax–inclusive, so that the person receiving the assets actually receives less as the tax will be paid out of that, if there is tax apportioning being applied. Tax

apportioning has to do with the person receiving the asset pays the tax liability on that asset rather than the residue being liable for the tax.

This question is there for the potential for generation-skipping gifts also. Should your client give to a skip person and not be penalized for it. In 2010, only, there is no generation-skipping transfer tax. The issue of the gift tax remains. Due to the numbers and the potential that the federal estate tax exemption amount will be set at $3.5M, this strategy might work best for those estates greater than $10M.

Again determine the result that the donor actually intends and work back from there. It does require spending some time with your clients to be sure they give you good instructions. In most cases, you will have to help your clients work through these issues as they will not consider them, much less bring them to your attention.

Trap #6: Effect on State Death Taxes

With the repeal of EGTTRA another issue is coming to the forefront. This one has been percolating ever closer to the surface for a number of years. In fact, several states have already pursued a course to offset this problem created for them by the repeal of EGTTRA.

As time progressed from 2001–2009, the pickup estate tax that the states received from the collection of the federal estate tax dwindled. It is now gone. This has had a negative impact on the states' budgets. The budgets of all states are straining from the lack of revenues to meet expenses. Their combined shortfall amounts to approximately $15 billion.

At least 14 states have enacted some sort of death tax. These include Connecticut, Indiana, Iowa, Kentucky, Louisiana, Maryland, Montana, New Hampshire, New Jersey, Ohio, Oklahoma, Pennsylvania, South Dakota and Tennessee.

Does the estate plan fit with state death taxes? This means that if your clients live in one of these states, owns property in one of these states or is contemplating relocating to one of these states, be cautious. Special attention will have to be paid. It might not be well received if the heirs are caught off guard that a death tax is due when they have heard how the death tax has been repealed. This also applies to after 2010. At this time it is unlikely that with the reinstatement of the federal estate tax, the above listed states will repeal their version of the death tax. Extra attention needs to be given in the drafting of your documents to minimize or eliminate this trap for the unwary.

Pay attention to what is going on in your state capital. Even if there is no state death tax in your state now, this does not mean one will not be forthcoming.

If your client is contemplating moving to a new state, be sure that client totally disengages from the old state or a tax may be due in both states.

Trap #7: Effect on Noncitizen Spouses

We are all familiar with the unlimited marital deduction available to surviving spouses that are U.S. citizens, when there was an estate tax in effect. But be aware that the unlimited marital deduction is not universally given to everyone. Transfers to a spouse who is a U.S. resident, but not a citizen will not qualify for an unlimited marital deduction without additional planning. If the surviving spouse is a nonresident non-U.S. citizen the unlimited marital deduction will not be allowed. The query is now, in 2010, what effect does the one-year repeal of federal estate tax have on the surviving spouse who is a U.S. resident but not a citizen, or the surviving spouse who is not a U.S. resident or a U.S. citizen?

Under the federal estate tax system applicable before, the surviving spouse who was not a U.S. citizen had to have a U.S. domiciled trustee to receive the unlimited marital deduction. With the repeal of the federal estate tax during 2010, this should mean that there is not a problem to be concerned with, correct? No federal estate tax should mean that there is an unlimited amount that can be passed from one spouse to another, without regard to residence or citizenship.

Is the surviving spouse a U.S. citizen and/or resident? That is not entirely accurate. Remember that with the repeal of the federal estate tax, the rule providing for the step up in basis at death also went away.

This becomes an issue with a nonresident, noncitizen surviving spouse. If a Marital Trust is properly established, the surviving spouse is entitled to an additional $3M of step up in basis. As we discussed, the basis adjustment is not on $3M in asset value but on $3M of appreciation in value. Here there is a divergent view as to whether or not this is available to the resident, noncitizen surviv-

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ing spouse. It is well settled that it is not available to the nonresident, noncitizen surviving spouse. It is questionable if it is available to the resident, noncitizen surviving spouse.

Internal Revenue Code (IRC) Section 1022 (a) (1) states: "Property acquired from a decedent dying after December 31, 2009, shall be treated for purposes of this subtitle as transferred by gift."

What does this mean? One interpretation is that Code Section 2503(i) applies. This would limit the noncitizen spousal value to the annual exclusion of $134,000 in 2010.What about the resident noncitizen? It is unclear.

Trap #8: Premarital Agreements

Be sure to review any premarital agreements that you are drafting this year or have in the last several years. Many of these may contain a funding formula. This may create a problem as discussed before. If there is a funding formula, be sure to counsel with your clients as to what the desired outcome is and draft to meet those needs. Does your client's premarital agreement have a funding clause in it?

What to Do to Protect Your Clients

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One of the challenging questions is what Congress will do in 2010 in terms of the federal estate tax. With this being an election year there are three viewpoints on what Congress will do:

- Enact a federal estate tax;
- Enact a federal estate tax and make it retroactive to January 1, 2010; or
- Do nothing and let the old law be reinstated.

Without knowing what course of action Congress may or will take makes your planning more tenuous. It makes planning sort of like attempting to navigate a minefield.

If Congress makes the law retroactive, what should be done with the Dynasty Trusts and generation-skipping trusts that have been established and funded?

What limits will Congress set for the federal estate tax exemption? There is talk of anywhere from $600,000 to $5M. Will there be portability of any unused marital exemption? There has been some discussion of that also. That would make post mortem planning a little less hazardous.

Will Congress eliminate rolling GRATs or GRATs with a term of less than ten years? All this uncertainty creates a golden opportunity for additional counseling with your clients and those they intend to pass their wealth onto.

Much of what estate planning has had to deal with remains the same. Getting your clients to formulate and vocalize their estate planning goals, aspirations and desires. Exactly what do they want to occur when they are looking down on the Earth and seeing what is taking place? It is more challenging, that is for sure, but in the end they should be making the determination as to which is more important to them:

- Asset protection;
- Taking care of their loved ones;
- Minimizing Taxes of any kind;
- Ensuring the surviving spouse is cared for in the quality of life that he or she had become accustomed to;
- Taking care of anyone with special needs;
- Medicaid planning;
- Charitable giving;
- Business succession; and/or
- Any other areas that are important to the client or the client's family.

The current environment makes it imperative that you have a detailed counseling session with your client and that you keep very good notes.

How will you advise your fiduciary to distribute the assets of the decedent in 2010? If you allow the early distribution to satisfy the demands of the beneficiaries, what will you do if Congress retroactively enacts a federal estate tax? Will you be able to get the money back from the beneficiaries to pay the tax?

Be sure to counsel your clients to fulfill their estate planning goals, aspirations and desires. Be sure to advise your client to pick a fiduciary wisely. Be sure that person is a good communicator and record keeper. Consider instructions that require the fiduciary to hire a CPA for income tax counsel.

The best practice is to invite all existing clients to schedule a conference to review their plans. In addition, you should review your current estate plans and those you have already prepared in light of these new issues. If a client dies in 2010 and you were not successful in moving the client to act to make necessary changes to his or her estate plan, you may petition a Court of competent jurisdiction to reform the trust. If you use the services of a trust protector or trust advisor, they might be able to correct for these issues. Think about inserting trust protector or trust advisor language into your documents.

You will have to have some in-depth conversations with your clients. It might even be advisable, with your client's permission, to have a discussion or two with the family so they are aware of what is coming. Be sure to include a statement of intent that covers the client's goals, aspirations, desires and reasons for pursuing the course that they did.

Case Study

Mom and Dad enter into a second marriage, with children being his, hers and theirs. They have a goal to minimize federal estate taxes. Dad dies in 2010. His oldest son is the Successor Trustee. Dad has transferred his small business and retirement plans into his trust and the trust worth approximately four million dollars. Mom did not get around to putting any of the assets into her trust after they got married. Dad's trust has the standard funding formula in it: that is, an amount goes in the family trust up to any amount that would create a federal estate tax liability, thereafter, any excess will be used to fund the remainder into the marital trust. Are there any issues with this set-up?

Mom has been successfully disinherited. With no federal estate tax in 2010, the marital trust will be unfunded; no assets will be transferred into it. If the Successor Trustee does fund the marital trust, might he be liable for making an unauthorized gift, and incur the wrath of the other beneficiaries who may lose that portion of their inheritance? What if Mom remarries and gives that money to her new husband or his children?

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