TAX LAW | By REBECCA ROSENBERGER SMOLEN

Planning for Death and Taxes in the 21st Century

One-Year Exemption on Federal Estate and GST Taxes Adds to Complexities for Attorneys Offering Advice

Benjamin Franklin once famously said something to the effect that nothing is as certain in life as death and taxes. While there's no question that remains an apt expression, 2010 has been somewhat of a "Twilight Zone" year for estate planners. For the first time in our careers, none of the estates of our clients who died in 2010 had federal estate tax to pay because it was repealed **for 2010 only**. Also repealed, for 2010 only, was the federal generation skipping transfer (GST) tax.

Although the wheels were set in motion for this one-year temporary repeal many years ago, largely attributable to the second President Bush's campaign promise to repeal the "death tax," most, if not all estate planning lawyers thought we would never see this tax environment. Up through December of 2009 we were still anticipating that Congress would act to avert this impossible-to-justify tax policy that results in significantly different federal estate and GST tax burdens for the estates of decedents who died in 2009, 2010 and 2011. For a Pennsylvania resident's estate of $10 million passing to children, in 2009, when a $3.5 million exemption was in place, the total federal estate and Pennsylvania inheritance taxes imposed would be $3,172,500, in 2010 there would be no federal estate taxes but a Pennsylvania inheritance tax of $450,000, and in 2011, when the exemption is scheduled to revert to $1 million, the total taxes due would be $4,795,000.

A further complication in the tax laws in 2010 is that there is not an unlimited stepped up basis for inherited property as has typically is the case is in every other year under Internal Revenue Code (IRC) Section 1014. Instead, there is a "carry-over basis" rule in effect which is similar to the rule that applies to inter vivos gifts of property under IRC Section 1015. There are also special allowances for allocating stepped-up basis to up to $1.3 million of gain to property passing to non-spouse beneficiaries and up to $3 million of gain to property passing for the benefit of a surviving spouse.

For the first half of 2010, estate planners were still bracing for a potential retroactive change to the 2010 estate tax laws, but, despite a few proposals in Congress, none have been enacted. We remain anxious to learn with greater certainty what the tax environment will be in 2011. If Congress doesn't act, as noted above, the exemption will remain at $1 million. However, there have been proposals to increase it to $2 million, $3.5 million or $5 million. While it's impossible to know what will happen, and based on this year's experience with congressional inertia, perhaps we should simply expect more of the same. The conventional wisdom has been that there will be a compromise at an exemption of $3.5 million, the exemption level that has been consistently supported by President Obama's platform.

One thing that appears nearly for certain, under the current political and economic climate, it is very unlikely that we will see a permanent repeal of the federal estate tax in the near future as had been the original objective of many of those in Congress (and President Bush) in setting the wheels in motion for 2010's one-year repeal. Back in 2001, when the one-year repeal and increased exemptions were voted into law by Congress, we were enjoying relatively good economic times and the federal budget hadn't yet been burdened with the costs of the Iraq war or the Katrina disaster.

Needless to say, it has been exceedingly difficult to give clients sound estate planning advice in this tax environment. However, estate planners have been busy, inter alia, with the following as result of the one-year repeal:

- Nationwide, including in Pennsylvania, we've been urging our state legislatures to pass laws to interpret formula clauses that contemplate the existence of the federal estate tax, in a uniform manner statewide to address the one year repeal.
- Working with surviving spouses to disclaim assets passing to them from their deceased spouses to maximize the benefits to their families from this year's repeal of the estate tax.
- Counseling families to take advantage of the one-year repeal in the federal generation skipping transfer tax by making outright gifts (and distributions from GST subject

trusts) to "skip persons" (i.e., grandchildren and more remote descendants).
- Counseling families to consider making gifts during 2010 to lock in the one-year 35 percent gift tax rate.

After going through the challenges of this year, and once we have more certainty for the future, it appears that going forward estate planning will seem much simpler by comparison. While much of our work is tax driven, a good deal is not. Clients always need to plan for potential incapacity and carefully structure who will receive their assets upon their deaths and under what terms. More and more frequently, as a result of our increasingly litigious society and the high divorce rate, as well as Pennsylvania's repeal of the "Rule Against Perpetuities" in recent years, clients have been gravitating toward creating perpetual trusts for their children to better protect their inheritances from claims of creditors and spouses in a divorce, as well as from their own potential spendthrift proclivities (in contrast to the typical trust structure in the past that would vest all of a child's inheritance by age 35). Also, out of recognition that a surviving spouse might remarry, irrespective of tax planning considerations, both husbands and wives have been gravitating toward structuring their asset base so that at least one-half of their joint assets will pass to the surviving spouse in a trust arrangement to better protect their life savings for their children out of recognition that the surviving spouse may remarry and develop new fiscal allegiances and obligations.

Here is a list of many of the tasks estate planners focus on to help our clients plan their estates divided into those that are sensitive to the federal estate tax structure (or mere existence) and those that are not:

FEDERAL ESTATE TAX SENSITIVE

- Allocation of assets between spouses for effectively using the Federal estate tax exemptions of each spouse (including use of inter-vivos QTIP Trusts).
- Use of exemption available to first spouse to die by either gift to non-spouse beneficiaries or trust structure that benefits the surviving spouse but bypasses his or her estate (including post-mortem disclaimer planning).
- Annual exclusion gifting to beneficiaries (2010 federal gift tax exclusion is $13,000 per donee).
- Creation of irrevocable trust to own life insurance since life insurance is subject to Federal estate tax despite its exemption from income tax.
- Transactions designed to leverage the federal gift and estate tax exemption of clients:

a. Qualified Personal Residence Trusts
b. Grantor Retained Annuity Trusts
c. Sales to Grantor Trusts
d. Private annuity transactions
e. Family Limited Partnerships
f. Discounted Fractional Interest Gifts
g. Charitable Remainder & Lead Trusts

NON-ESTATE TAX SENSITIVE

- Incapacity planning - General power of attorney, health care power of attorney and living will.
- Naming guardians for minor children.
- Naming executors and trustees.
- Trust structure for surviving spouse to protect all or part of joint assets for children.
- Trust structure for children.
- Charitable gift planning – addressing donor intent and income tax planning.
- Designating contingent beneficiaries of estate in the event of family catastrophe.
- Properly integrating non-probate assets into estate plan (i.e., life insurance, retirement accounts, annuities).
- Planning for maximum income tax deferral for IRAs and Qualified Retirement Accounts for beneficiaries (i.e., IRA stretchout).

As you can see, there are plenty of important tasks unrelated to the federal estate tax for estate planners to address for clients. So, regardless of what Congress does in the future to further tinker with the federal estate and generation skipping transfer tax systems, for the reasons that Ben Franklin noted so long ago, estate planning attorneys will remain busy well into the 21st century and beyond. ■

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