

private client services update

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NO FEDERAL ESTATE OR GST TAX! ARE THESE THE BEST OF TAX TIMES OR THE WORST OF TAX TIMES?

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At best, these are complicated times for estate planning. What Congress will do with estate, gift and generation skipping transfer (“GST”) taxes is anyone’s guess. For now, (a) no federal estate tax is imposed on any transfers at death, (b) the gift tax rate is reduced to 35%, (c) no GST tax is imposed on any transfers to “skip” generations, and (d) only a limited amount of assets are entitled to a “step-up” in tax basis. Many practitioners expect that Congress will pass legislation some time during the course of 2010 reinstating the estate and GST taxes with exemptions of at least \$3.5 million. It is further expected that such legislation will be retroactive to January 1, 2010. Absent such legislation in 2010, the current transfer tax regime will end January 1, 2011; estate and GST tax exemptions will return to \$1 million, the maximum estate, gift and GST tax rates will increase to a maximum of 55%, and “carry-over” basis will end. While few practitioners, if any, expect that the current transfer tax regime will expire before Congress passes new legislation, few if any expected that Congress would allow the repeal of federal estate and gift tax laws to occur.

As a result of Congressional inaction, many estate plans may no longer meet clients’ objectives. This is because many wills and revocable trusts make dispositions by reference to the pre-2010 transfer tax provisions of the Internal Revenue Code (the “Code”), particularly the terminology and definitions, including “unified credit,” “marital deduction,” “charitable deduction” and “taxable estate.” If there is no estate tax, these provisions are meaningless in interpreting and administering an estate plan. For example, a provision leaving to a beneficiary “the minimum amount needed to reduce federal estate tax to zero” would pass nothing to that beneficiary; likewise, a provision leaving to a beneficiary “the maximum amount that can pass free of federal estate tax” would pass everything to that beneficiary. Even under the 2009 estate tax exemption amount of \$3.5 million, many estate plans, drafted with the expectation of lower exemption amounts, have become out of date and inconsistent with clients’ dispositive intentions.

The Trust Funding Problem

These problems are particularly prevalent in the context of trusts funded under wills and revocable trusts. The standard estate planning practice for married couples for decades has been to divide the estate of the first spouse to die into a “Marital Trust” (or in many cases, a marital share) and a “Family Trust” (also commonly known as a “Credit Shelter Trust” or “Bypass Trust”). Funding of the Family Trust and the Marital Trust or marital share usually would be based upon one of a variety of possible pecuniary or fractional funding formulas, depending upon the couple’s objectives and circumstances, but with the ultimate goal of using the deceased spouse’s unused exemption.

For example, a Family Trust may be funded with an amount “equal to the largest amount, if any, that can pass free of federal estate tax . . . by reason of the applicable credit amount.” Alternatively, a Family Trust may be funded as a fraction of the residuary trust fund, “the numerator of which fraction shall be the largest amount that can pass free of federal estate tax . . . by reason of all credits (such as the unified credit) available to the Grantor’s estate. . . . The denominator of the fraction shall equal the value of the Residuary Trust Fund as finally determined for

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federal estate tax purposes.” The Marital Trust share or the marital share would be the fractional share of the residuary trust fund remaining after computing the Family Trust fractional share. Still another variation funds the Marital Trust first, with a formula such as, “the lesser of the marital deduction allowable to my estate or the minimum amount necessary to reduce my federal estate taxes to zero.” Many other variations exist, all with the same fundamental problem: each funding formula contains some reference to Code provisions governing transfer taxes that are not longer applicable, and that may cause funding of a trust that is substantially greater than the couple envisioned when the original estate plan was created. And these funding issues extend to GST trusts and charitable trusts as well.

Possible Solutions

1. *A potential state law fix*; Virginia lawmakers have proposed a modification of Virginia Code § 64.1-62.2, which would be applicable to the will or trust of a decedent who dies after December 31, 2009, and before January 1, 2011. Under the legislative proposal, formulas based on provisions of federal estate tax or GST tax laws would be deemed to refer to the federal estate tax law or GST tax laws as they applied with respect to estates of decedents dying on December 31, 2009. The law would not apply to a will or trust that is executed or amended after December 31, 2009, or that manifests an intent that a contrary rule should apply.
2. *“Saving” provisions in existing estate planning documents*; It is possible that the dispositive document contains provisions taking into account the possibility of repeal, or if it does not, it may contain some other “savings” language, such as a cap.
3. *Amendment of existing estate planning documents*; Updating presents a new set of dilemmas, as the future of federal transfer tax laws is uncertain. Flexibility is therefore a plan imperative.

a. Disclaimer Funding. In the case of a harmonious, traditional family, assets could be left outright to the surviving spouse who may cause a family trust to be funded by disclaiming certain assets within 9 months following the death of the decedent spouse and complying with all other laws and regulations applicable to disclaimers.

b. Marital Trust Option. In the years for which there is an estate tax, an outright bequest of assets to a surviving spouse automatically qualifies for the unlimited marital deduction, however, the assets held by the surviving spouse at his or her death will be automatically taxed as part of the surviving spouse’s estate. In contrast, assets in a marital trust will generally only be taxed as part of a surviving spouse’s estate if an election to qualify it for the unlimited marital deduction (a qualified terminable interest property, or “QTIP,” election) is made on the estate tax return. Absent such a QTIP election, the estate will not get a marital deduction, and the marital trust property will be taxed as part of the estate of the first to die, rather than as part of the surviving spouse’s estate at his or her death. The executor with a marital trust in the estate plan therefore has the flexibility to minimize estate taxes as the circumstances dictate.

Thus, if there is no federal estate tax in effect at the death of the first spouse to die, no QTIP election would be made and the marital trust should therefore not be taxed in the surviving spouse’s estate, if federal estate tax is reinstated before the surviving spouse’s death (unless the reinstatement is made retroactive). Alternatively, if the federal estate tax has been reinstated before the death of the first spouse to die, a full or partial QTIP election could be made to ensure that no estate tax would be owed at the death of the first spouse to die, but the portion of the marital trust subject to the QTIP election would be taxed as part of the surviving spouse’s estate at his or her later death.

c. Inclusion of All Options. For spouses who wish to retain maximum control of the disposition of their assets, the will or trust documents can provide expressly for the actual status of federal estate, gift and

GST tax at the time of death: (i) full repeal of estate and GST tax under current law, (ii) estate and GST tax exemptions of \$1 million as of January 1, 2011, if new legislation is not enacted, or (iii) a tax exemption of unknown amount, potentially varying over time.

d. Post-Death Termination of an Unnecessary Family Trust. For individuals who do not address the effect of changes in the law on their estate planning documents, the Virginia Uniform Trust Code (“UTC”) may provide some relief in limited circumstances. Specifically, the UTC permits the termination of uneconomic or ineffective trusts, and provides for modification or termination of an irrevocable trust under certain circumstances. Under § 55-544.10 of the Virginia Code, “a trust terminates to the extent . . . no purpose of the trust remains to be achieved, or the purposes of the trust have become . . . impossible to achieve.”

Additionally, under Virginia Code § 55-544-11, a noncharitable trust that has become irrevocable because of the death of the settlor may be terminated upon consent of all of the beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust, and a noncharitable irrevocable trust may be modified upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust. Upon termination of a trust, the trustee must distribute the trust property as agreed by the beneficiaries. If not all of the beneficiaries consent to a proposed modification or termination of the trust (as in the case of a minor beneficiary who cannot consent, for example), the modification or termination may be approved by the court if the court is satisfied that (i) if all of the beneficiaries had consented, the trust could have been modified or terminated; and (ii) the interests of a beneficiary who does not consent will be adequately protected.

Finally, under Virginia Code § 55-544-12, a court “may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. To the extent practicable, the modification shall be made in accordance with the settlor’s probable intention.” Upon termination of a trust, the trustee must distribute the trust property in a manner consistent with the purposes of the trust.

In determining whether or not to terminate an existing Family Trust, the beneficiaries should weigh the following factors:

- the costs of administering the trust against the costs of terminating the trust;
- the potential for appreciation of the family trust assets outside of the estate of the surviving spouse, in the event that the estate tax is reinstated, if the surviving spouse will be the recipient of the assets upon the early termination; and
- the GST tax consequences, if any.

The Carry-Over Basis Problem

None of the proposed solutions offer a fix to the headache of carry-over basis. Income tax basis is a number (typically the original purchase price with some adjustments, depending upon the asset) from which capital gain or loss upon sale of the asset is measured. Under the old rules, the tax basis of an asset received from a decedent was increased, or “stepped-up,” to the fair market value of the asset on the decedent’s date of death. Under the law in effect for 2010, there is no step-up; instead, a beneficiary’s tax basis in an asset received from a decedent is the lesser of the existing adjusted basis of the asset or its fair market value as of the date of death—the “carry-over” basis. The executor of an estate may elect a “Special Basis Adjustment,” to increase the basis of appreciated property by \$1.3 million. The executor may also elect to make a “Spousal Basis Adjustment” to increase the basis of the property transferring to the surviving spouse either outright or as qualifying terminable interest property, up to an additional \$3 million. For many taxpayers, the new basis rule will cause an imposition of income tax at some point, whereas under the old law and credit amounts, there would have been no estate

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or income tax.

Estate Planning and Estate Administration is More Complex Than Ever

Although the world of estate planning and estate administration is more complex than ever, with a proactive approach and thoughtful review of the circumstances and opportunities, where the situation warrants, it is possible to exert some control over the future and to maximize tax efficiency . . . until Congress throws us another curve ball.

Individuals should promptly consult with their legal and tax advisors in any of the following situation:

- they are at significant risk of death in 2010;
- their existing documents provide for an amount of money to pass in a manner that does not benefit their spouse and that amount is tied to the estate or GST tax exemption (this is more typically found in second marriages with children from a prior marriage); or
- they have any concerns about their estate plan.



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