Insight on Estate Planning

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Tax Relief act provides *temporary* certainty for your estate plan

In recent years, estate planning has been a challenge. After all, a big part of the process involves minimizing gift and estate taxes — a difficult thing to do when the future of those taxes is uncertain. The recently enacted Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 provides welcome certainty in regard to estate planning, but only through 2012.

Years of estate tax uncertainty

For the past few years, changes in the federal estate tax regime have felt like a slow-motion roller coaster. Just consider someone planning his or her estate in 2009. That year, the top rate for gift, estate and generation-skipping transfer (GST) taxes was 45%; the estate and GST tax exemptions stood at $3.5 million, with a $1 million exemption for lifetime gifts; and inherited assets were entitled to a stepped-up basis, allowing them to potentially be sold free of capital gains taxes.

Effective Jan. 1, 2010, under the 2001 tax act the estate and GST taxes were repealed; the gift tax rate dropped to 35%, with a $1 million exemption; and the stepped-up basis rules were replaced by modified carryover basis rules that created income tax concerns for many families.

Historically, assets transferred at death had been entitled to a stepped-up basis. In other words, an asset's tax basis would be increased from the deceased's adjusted cost basis to its fair market value on the date of death, allowing the recipient to possibly sell the asset without generating a capital gains tax liability. The purpose of this rule was to avoid subjecting the same assets to *both* income and estate taxes.

With the estate tax repeal, this double taxation was no longer an issue, so the 2001 tax act eliminated the stepped-up basis rules. For people who died in 2010, the 2001 tax act called for heirs to take a carryover basis in inherited assets — generally equal to the deceased's cost basis — potentially resulting in significant capital gains tax on appreciated assets.

To soften the income tax blow, however, the 2001 tax act generally allowed a step-up in basis of $1.3 million. An additional $3 million of step-up was allowed for assets left to a surviving spouse.

Finally, the 2001 act called for the reinstatement of the pre-2001-tax-act estate tax regime in 2011 — that is, a top rate of 55% for gift, estate and GST taxes; a $1 million combined gift and estate tax exemption; a $1 million (indexed for inflation) GST exemption; and the return of the generally unlimited step-up in basis.

Estate tax stability, temporarily

The 2010 Tax Relief act provides some consistency and certainty by reinstating the estate tax, with a top rate of 35% and a $5 million

Transfer tax exemptions and rates for 2009–2013

	2009	2010	2011	2012	2013
Gift tax exemption	$1 million	$1 million	$5 million	$5 million[2]	$1 million
Estate tax exemption[1]	$3.5 million	$5 million[3]	$5 million	$5 million[2]	$1 million
Generation-skipping transfer (GST) tax exemption	$3.5 million	$5 million	$5 million	$5 million[2]	$1 million[2]
Highest gift and estate tax rates and GST tax rate	45%	35%[3] 0% for GST tax	35%	35%	55%[4]

[1] Less any gift tax exemption already used during life. For 2011 and 2012, these amounts are "portable" between spouses.

[2] Indexed for inflation.

[3] Estates can elect to follow the pre-2010 Tax Relief act regime (estate tax repeal + limited step-up in basis).

[4] The benefits of the graduated gift and estate tax rates and exemptions are phased out for gifts/estates over $10 million.

exemption — for people dying after Dec. 31, 2009, and before Jan. 1, 2013. It also restores the stepped-up basis rules.

In addition, the 2010 Tax Relief act:

- Maintains the 35% gift tax and $1 million exemption for gifts made in 2010; for gifts made in 2011 and 2012, the 35% rate continues to apply, but a $5 million unified exemption applies to both lifetime gifts and bequests at death.
- Reinstates the GST tax for people dying after Dec. 31, 2009, and before Jan. 1, 2013, with a $5 million exemption — the GST tax rate, however, is zero in 2010, increasing to 35% in 2011 and 2012.
- Makes the $5 million estate tax exemption (but not the GST tax exemption) "portable" for married couples in 2011 and 2012. If one spouse dies without using up the exemption (and an election is made on a timely filed estate tax return), the surviving spouse can add the unused portion to his or her own exemption and use it to make tax-free gifts or bequests.

Bear in mind that this new estate tax regime is temporary, which means that, unless Congress extends it or makes it permanent, uncertainty over its future will continue to complicate estate planning. For now, rates and exemptions are scheduled to return to the pre-2001-tax-act regime in 2013.

One provision offers some hope, however: The Tax Relief act provides for the $5 million exemptions to be adjusted for inflation in 2012, which may suggest that lawmakers expect this version of the estate tax regime to be around for a while.

A choice to make for 2010

If you had a loved one who died in 2010, you may have a critical decision to make: The 2010 Tax Relief act allows the estate of someone who died in 2010 to choose between the new estate tax regime and the 2001 tax act regime — that is, no estate tax, and with the modified carryover basis rules for inherited assets. Fortunately, the 2010 act gives the estates of people who died after Dec. 31, 2009, and before Dec. 17, 2010, an additional nine months to file estate tax returns and take certain other actions. ∎

3 postmortem strategies that add flexibility to your estate plan

In recent years, estate planning has been complicated by uncertainty over the future of the federal gift and estate tax regime. But even when estate tax rates and exemption amounts are predictable, changing family circumstances make planning a challenge. Fortunately, there are several postmortem strategies your family can use to ensure that your wishes are carried out. Let's take a closer look at three such strategies.

1. Disclaimers

A disclaimer is an irrevocable, unqualified refusal by a beneficiary to accept a bequest, allowing the property to pass to another beneficiary. Normally, using a disclaimer to direct property to someone else would be considered a taxable gift. But there's an exception for "qualified" disclaimers. To qualify, a disclaimer must:

- Be in writing,
- Be delivered to the estate's representative within nine months after the transfer is made (or, if the disclaimant is a minor, within nine months after the disclaimant turns 21),
- Be delivered before the disclaimant accepts the property or any of its benefits, and
- Cause the property to pass to the deceased's surviving spouse or to someone other than the disclaimant, without any direction from the disclaimant.

This last point is critical and requires some planning on your part. To ensure that the disclaimant doesn't direct the property's disposition, the property must pass automatically to a contingent beneficiary according to the terms of your will or trust.

For example, let's say Harry's will leaves all of his assets outright to his wife, Sally or, in the event she doesn't survive him, to their children. When Harry dies, his estate passes to Sally, and the unlimited marital deduction shields the entire amount from estate taxes. When Sally dies, however, her estate is subject to estate taxes because it exceeds her available estate tax exemption.

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Suppose, instead, that Sally disclaims a portion of her inheritance equal to Harry's available estate tax exemption. That amount then passes to their children estate-tax free by virtue of Harry's exemption. The amount that goes to Sally is sheltered from tax by the marital deduction and, when she dies, some or all of it is sheltered by her own estate tax exemption. In other words, the disclaimer strategy can reduce or even eliminate taxes on the couple's estates.

2. Spousal right of election

Another strategy for redistributing your wealth after you're gone is the spousal right of election. In most states, a surviving spouse has the right to circumvent your will and take an elective share (one-half or one-third, for instance) of certain property. So, for example, if you leave all of your assets to your children or other beneficiaries, your spouse might exercise his or her right of election if it would produce a more favorable tax outcome. Check with your estate planning advisor to see if this strategy is applicable in your state.

Keep in mind, however, that exercise of the election with respect to property held in charitable remainder trusts may disqualify those trusts.

3. QTIP trust

Qualified terminable interest property (QTIP) trusts are often used to take advantage of the marital deduction while ensuring that assets are preserved for the children (particularly children from a previous marriage) and receive some creditor protection.

Ordinarily, to qualify for the marital deduction, you must transfer assets to your spouse with no strings attached. The QTIP trust is an exception to this rule. So long as your spouse receives all of the trust income for life and certain other requirements are met, you can enjoy the benefits of the marital deduction while still preserving assets for your children or other beneficiaries. When your spouse dies, any remaining trust assets pass to your beneficiaries but are taxed as part of your spouse's estate.

Even if you don't need a QTIP trust to protect your children or preserve your assets, it may still be a good strategy. Why? Because it creates opportunities for postmortem estate planning.

One of the requirements for QTIP status is that your executor or personal representative make a QTIP election on your estate tax return to have the marital deduction apply to the transfer to the trust. This gives the flexibility to make the election, not make the election or even make a partial election, depending on which strategy would produce the optimal results.

Suppose, for example, that when you die Congress has substantially increased the federal estate tax exemption. If the marital deduction isn't necessary to avoid estate taxes, your representative might decline to file a QTIP election and instead apply your estate tax exemption to the transfer. That way, when your spouse dies, the trust assets will pass to your children tax free, regardless of any future changes in estate tax rates or exemption amounts.

Review your plan

Ideally, you should revisit your estate plan periodically and make revisions to reflect new legislation or changes in your personal circumstances. In addition, consider designing your plan to maximize opportunities for postmortem planning strategies, such as those discussed here.

Can a SCIN allow you to reach estate planning goals?

When creating or revising your estate plan, it's important to consider the status of your health, because your life span can affect certain strategies. If you're in good health, you don't have to worry too much about the mortality risk inherent in, say, a grantor retained annuity trust.

But if your health is on the decline and you think you won't reach your actuarial life expectancy, consider looking for alternatives with less mortality risk. A self-canceling installment note (SCIN) may be an option to consider.

Taking note

To use a SCIN in estate planning, you sell your business or other assets to your children or other family members (or to a trust for their benefit) in exchange for an interest-bearing installment note. As long as the purchase price is for full value and the interest rate is adequate, there's no taxable gift involved. So you can take advantage of a SCIN without having to use up any of your lifetime gift tax exemption or annual gift tax exclusions. As discussed below, however, a SCIN must include a premium.

The "self-canceling" feature means that if you die during the note's term — which must be no longer than your actuarial life expectancy at the time of the transaction — your buyer is relieved of any future payment obligations. (Be aware that, if you're currently terminally ill, you can't use a SCIN.)

A SCIN offers a variety of valuable tax benefits. If you die before the note matures, the outstanding principal is excluded from your estate, allowing you to transfer a significant amount of wealth to your children or other family members estate-tax free. They can also benefit by being able to deduct the interest they pay on the note.

Finally, you can defer capital gain on the sale by spreading it over the note term. If you die before the note matures, however, the remaining capital gain will be taxed to your estate even though no more payments will be received.

In addition to these benefits, any appreciation in the assets' value after the sale is also excluded from your estate.

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Paying the premium

Like most things in life, you can't get something for nothing. To compensate you for the risk that the note will be canceled and the full purchase price won't be paid, the buyers must pay the aforementioned premium — in the form of either a higher purchase price or a higher interest rate.

Your estate planning advisor can calculate the premium based on statistical probabilities. But if the premium is too low, the IRS may treat the transaction as a partial gift and assess gift taxes — or worse, include the entire value of the sold assets in the estate as a retained interest.

Either type of premium will work, but each may involve different tax considerations. If you add a premium to the purchase price, for example, a greater portion of each installment will be taxed to you at the more favorable capital gains rate, and the buyers' basis will be larger. On the other hand, an interest-rate premium increases the buyers' income tax deductions.

The premium catch also comes with risk. In fact, SCINs present the opposite of mortality risk: The tax benefits are lost if you live *longer* than expected. If you survive the term of the note, the buyers will have paid a premium for the assets, and your estate may end up *larger* rather than smaller than before.

Is a SCIN right for you?

If you're in declining health, it may be a good time to revise your estate plan to include a SCIN. Just be aware that this powerful strategy comes with the risk that you'll outlive the installment note's term. Your estate planning advisor can help you determine whether a SCIN is right for your situation. ∎

Estate Planning Pitfall

You're unsure whether life insurance proceeds will be tax free

Typically, proceeds from life insurance policies are *income*-tax free. The bigger risk is that life insurance proceeds will be subject to *estate* taxes. If you own a policy on your own life — or even retain any "incidents of ownership," such as the right to change beneficiaries or the right to borrow — the proceeds will be included in your taxable estate.

A highly effective way to avoid estate taxes on life insurance proceeds is to have an irrevocable life insurance trust (ILIT) hold the policy. You make periodic contributions to the trust to cover the premiums. When you die, the proceeds are paid to the trust estate-tax free and distributed to your beneficiaries according to the trust's terms.

Contributions are subject to gift tax, but in many cases they can be structured so that they fall within the $13,000 annual gift tax exclusion or lifetime exemption.

Ideally, you would establish an ILIT and have the trust purchase the policy. If you purchase the policy yourself and then transfer it to the ILIT, the proceeds will be pulled back into your estate if you die within three years after making the transfer. It may be possible to avoid this three-year rule, however, by selling a policy to the ILIT.

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