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ESTATE PLANNING PRACTICE AFTER ATRA

Most clients do not engage in the estate planning exercise for entertainment. Few of them have the thought, "What a great day it will be, because I get to talk to my advisors about dying."

For most of my professional life, the primary motivating influence causing clients to engage in the estate planning process has been the specter of unnecessary estate taxes levied upon the family. Historically, that fear was applicable to a substantial portion of the adult population. Therefore, it has been easy for estate planners to be lazy about promoting the other primary benefits to be achieved through the estate planning process, and simply rely on the estate tax threat to motivate people to walk into our offices.

- When I began my career, the estate tax "exemption" was only $60,000, and the marital deduction was limited to ½ of the adjusted gross estate. The maximum estate tax rate was 77%. Most people with enough discretionary wealth to pay for estate planning advice were subject to the tax, and were motivated to do what was possible to avoid it. That was sufficient motivation for them to spend some time (and money) talking to an advisor about dying.

- In the 1976 tax act, the gift tax and estate tax systems were "unified" in their present form, and the concept of the "unified credit" was introduced. The "exemption equivalent" in 1977 increased to $120,000, and with annual increases over a ten year period until it reached $600,000 in 1987. The maximum estate tax rate in 1977 was 70%. The complexity of this new "unified" approach, together with an exemption of only $120,000, continued to provide strong motivation for clients to engage in estate planning to reduce the tax cost to the family.

- In 1982, the marital deduction became unlimited. The exemption equivalent had increased to $225,000. Many of our clients had to revise their estate planning documents in order to take advantage of the unlimited marital deduction, and there was still ample exposure to the estate tax to provide motivation to engage in the estate planning exercise.

- From 1987 through 1997, the exemption equivalent was fixed at $600,000, and the maximum estate tax rate reduced to 55%. In 1997, Congress adopted a schedule under which the exemption would gradually increase to $1,000,000 by 2006. With proper planning, a married couple could utilize the exemptions of both spouses, sheltering estates from the tax up to $1,200,000 to $2,000,000. That opportunity continued to provide substantial motivation to plan.

- The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased the exemption to $1,000,000 beginning in 2002, and adopted a schedule under which the exemption would continue to increase until it reached $3,500,000 in 2009. (Still, only $1,000,000 of the exemption could be used for gift tax purposes during life.) The estate tax would then be eliminated for persons dying in 2010, but the entire Act would "sunset" in 2011 unless Congress adopted some permanent reformation. Few people thought Congress would ultimately repeal the tax, and most thought that we would eventually have a permanent exemption of $3,500,000 which may or may not be indexed for inflation. However, if Congress did not implement something by 2011, the exemption would revert to the $1,000,000 level applicable in 2001. The uncertainty resulting from the inability of Congress to tackle this problem led to widespread apathy among moderately wealthy clients. Most already had documents which would optimize whatever the exemption amount was at death, and were not motivated to engage in further planning until a clear picture of the tax environment became available.

- In the Tax Reform Act of 2010, Congress admitted that it had been unable to implement a permanent approach to the estate tax question, and "kicked the can down the road." They surprisingly adopted a temporary $5,000,000 exemption amount for 2011 and 2012, allowed the full exemption amount to be used for both lifetime gifts and transfers at death, and made any unused exemption "portable" between spouses so that the full $10,000,000 could be available without engaging in sophisticated planning. The estate tax rate on any taxable portion of the estate was reduced to only 35%. Congress also provided 2010 decedents with a choice between zero estate tax and the income tax consequences thereof (as had been included in the 2001 Act), or imposition of the estate tax with a $5,000,000 exemption and the full income tax benefit of basis step-up on all estate property. They also reduced the estate tax rate on any taxable portion of the estate to only 35%. Again, unless Congress adopted a permanent approach before 2013, everything would revert to the 2001 exemption amount and tax rates. Most clients were not motivated to engage in any sophisticated estate planning until the end of 2012, when it appeared that Congress would again fail to act and the $5,000,000 exemption might be lost. In the last few months of 2012, an unprecedented number of people were sufficiently motivated to "talk to their lawyer about dying" because of a perceived estate tax emergency. They wanted to investigate what planning options were available in order to preserve the $5,000,000 exemption before it was lost. <u>This lack of action for the past several years, followed by a frenzy at the end of 2012 motivated entirely by perceived tax issues, confirms that most clients are motivated to engage in the planning process only when pushed to do so by the estate tax goblin.</u>

- Shortly after the end of 2012 (so shortly that Congress had not actually recessed and titled ATRA as a 2012 tax act), Congress implemented The American

Taxpayer Relief Act of 2012. It has made the primary features of the 2010 tax law permanent, including:

- $5,000,000 exemption (indexed for inflation, now $5,250,000);
- the full exemption is eligible for lifetime gifts;
- portability of unused exemption amount between spouses; and
- a tax rate of only 40%.

Consider the impact of these historical changes in the estate tax law on the population of prospective clients who might find value in our estate planning services. If they are motivated primarily by the threat of the estate tax cost to their family, then the population of those decedents with estates large enough to require filing an estate tax return would be a valid indication of the market for our services. The following table was part of a report published by the Senate Finance Committee in November 2007:

Year	Deaths	Number	% of Deaths
1970	1,796,940	93,424[2]	5.20
1973	1,867,689	120,761[2]	6.47
1977	1,819,107	139,115[2]	7.65
1982	1,897,820	41,620[2,3]	2.19
1984	1,968,128	31,507[2,3]	1.60
1986	2,105,361	23,731	1.13
1988	2,167,999	18,948	0.87
1990[4]	2,148,463	23,215	1.08
1992[4]	2,175,613	27,187	1.25
1994[4]	2,278,994	31,918	1.40
1996[4]	2,314,690	37,711	1.63
1998[4]	2,337,256	47,483	2.03
2000[4]	2,403,351	51,159	2.12
2002[4]	2,443,387	28,074	1.15
2004[4]	2,397,615	19,294	0.80

In the mid-1970s, almost 8 percent of all US decedents had estates of sufficient value to require filing an estate tax return. Between 120,000 and 140,000 estate tax returns were filed annually in those years.

After the enactment of the 1976 Tax Act, when the exemption was increased to $120,000 with planned growth to $600,000, only about 2 percent of US decedents were subject to the estate tax.

In 2000, before EGTRRA was enacted, almost 51,200 estates were taxable, representing 2.12 percent of adult deaths in that year. EGTRRA increased the exemption to $1,000,000, reducing the percentage of estates that were taxable. For example, 17,400 taxable estate tax returns were filed in 2007 representing about 0.7 percent of adult deaths.

It is estimated by the Tax Policy Committee that, after ATRA, only about 7,000 estate tax returns will be filed each year, which should represent less than 0.4 percent of adult deaths.

If we continue to rely on the estate tax threat as the primary motivation for clients to engage in the planning process, then our prospective clients have virtually disappeared!

Note, however, that tax planning should <u>never</u> be the dominant objective in the design of an estate plan. Estate planning is properly a goal-oriented exercise, and should always begin by encouraging the client to establish his or her objectives and priorities. **If the only priority they can specify is to reduce estate taxes, then they simply haven't thought about it enough**. Otherwise, one might suggest that they just leave the estate to a favorite charity, which will always be exempt from tax, and see if they are satisfied with that result.

Most experienced estate planners will agree that, over the years, most of their clients have ultimately expressed important priorities which have nothing to do with tax reduction, yet involved the use of trusts or other estate planning vehicles to ensure that those goals would be accomplished. In fact, many people with estates valued at less than $5+ million (or couples with less than $10+ million) will continue to have important planning objectives for which the use of trusts remains a valuable alternative.

For example:

- Revocable trusts will continue to be useful

  (with or without prenuptial agreements) to keep non-marital assets separate after a marriage; or

  to provide for the management of one's financial affairs in the event of incapacity; or

  to reduce the costs of probate and administration in some states; or

  to provide some privacy with respect to the terms of the disposition of one's estate.

- Those with children who are not yet fully mature find trusts to be extremely flexible in their selection of the person or persons (trustees) who should manage the property while the children are young, yet ensure that the economic benefits are available to fulfill the support and education needs of the children.

- Young couples realize that, if either of them die prematurely, it is likely that the survivor may remarry. Trusts can provide the surviving spouse with the economic benefits of their wealth, while ensuring that the remainder must eventually pass to their children rather than to the family of the survivor's second spouse.

- Older couples often worry that, if either of them were to die, the survivor might be vulnerable to a much younger suitor with designs on diverting the benefits of the family's wealth to themselves. Trusts can avoid such risks.
- Couples with children by more than one marriage will find trusts valuable to ensure that all the children are treated as they intend regardless of which spouse dies first and which survives.
- Many people wish to provide their beneficiaries with some protection of the assets against threats which might arise from business reversals, financial challenges, and marital problems. Properly designed trusts are popular to provide one's spouse and children with all of the economic benefits of the family's wealth, and even with broad control of the property through serving as trustee, while substantially shielding the property from such threats.
- Where the family wealth includes an ownership interest in a closely-held business, the use of one or more trusts to hold those equity interests can prevent fractionalizing the voting rights, and allow flexibility in selecting the appropriate members of each generation to exercise management control, yet ensure that all of the beneficiaries are treated "equally" as to the economic benefits.
- Where the family includes a "special needs" beneficiary, a properly constructed trust can provide economic benefits in addition to those which may be available through Medicaid or other public support programs, without jeopardizing the beneficiary's eligibility to qualify for such programs.
- Families with "sacred" assets attributable to one spouse's ancestors can use trusts to provide the surviving spouse with the economic benefit of such assets, while ensuring that the ownership can't move outside the appropriate bloodline.
- Family partnerships or LLCs will continue to be useful

    to hold real estate in other states to avoid probate and death taxes imposed by those states; or

    to divide ownership of assets among family members without actually fractionalizing the title to the property; or

    to retain centralized management control where the economic benefits are spread among multiple people; or

    to protect assets from the claims of creditors, litigants, spouses, or others; or

    to utilize valuation discounts to avoid income taxes in certain transactions.

In addition, after implementing the income tax changes of ATRA, planning to minimize income taxes will be a more important part of the estate planning strategy.

- Trusts allow investment income to be "sprinkled" among numerous beneficiaries, and subject to tax in the hands of the beneficiary who actually receives it. In most families, the surviving spouse may be in a higher bracket, and needs to provide support for children and grandchildren who are both in a lower bracket and not subject to the 3.8% Medicare surtax. Without a trust, all the income would be received by and taxable to the surviving spouse is his/her tax bracket. With a trust, income can be distributed to or for the children or grandchildren in their lower tax brackets.
- Property includible in one's gross estate for estate tax purposes will receive a basis adjustment to its fair market value at date of death. For families which own low-basis property, planning to qualify for that basis step-up upon the death of <u>either</u> spouse will be important.
- The sale of low basis property will now be subject to tax on the capital gain (federal and state plus Medicare surtax) at either about 22.4% or about 27.4%. That will be sufficiently large to encourage clients to look at charitable remainder trusts (and wealth replacement trusts funded with life insurance), as was common before 2002.
- The use of grantor trusts to sell a family business interest to the younger generation without incurring the tax on a capital gain will continue to be a valuable planning tool.
- Deferred compensation and split-dollar insurance plans will continue to provide some taxpayers with significant opportunities to reduce income taxes.
- Trusts will continue to be useful lifetime planning tools in the diversion of family income to children and grandchildren in lower income tax brackets without incurring a taxable gift.

These opportunities represent much to be offered, which might be an enticement to engage in the estate planning process <u>if</u> the prospective client is aware of the possibilities. The successful estate planning practice of the future will be one which provides effective education to make people aware of the scope of valuable services available. If one continues to rely entirely on the estate tax threat to motivate clients to call, the numbers show that is likely to get very lonely.

There are also many clients for whom we have implemented effective estate tax planning in the past, who do not need those "complicated" documents after ATRA. Many of them will be interested in simplifying things for their family, but only if it can be done at a reasonable cost. The lawyers who have invested in a "systems" approach to drafting documents efficiently, while still addressing the individual needs of the client, will be able to make those changes economically, and use that opportunity to inform clients of the other valuable uses of trusts and more complex estate planning vehicles.

For those of us who are compensated primarily based on the time required to accomplish a task for a client, time management will be more difficult. In the past, we could determine very quickly that a client's documents were going to be "forced" into a certain mold, driven by the structure of the tax law, based on the size of the estate. Going forward, many people will find that, without any external force driving the structure of the estate disposition plan, clients can come up with very unusual, arcane wishes which seem simple to them but which cannot be implemented without spending a lot of drafting time.

Finally, estate plans must at some point be implemented. A client will die, and the family will need assistance in managing the estate administration process. There may not be an estate tax issue to be resolved in the estate, but there will be questions, confusion, disagreements among family members, and a need to ensure that the decedent's wishes are carried out.