# Estate Planning in Uncertain Times

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*Although the changes made to the gift and estate tax laws were intended to simplify estate planning for the vast majority of Americans, we now have a more complex system than ever before. As a result, estate planners should develop flexible and more advanced techniques in order to respond to the constantly changing legal environment. This discussion provides an overview of the current estate planning environment. And, this discussion provides an outline of several techniques that may be useful to the estate planner.*

## Introduction

Here we are at the end of 2009, and 2010 was never supposed to get here. Under the current tax law, once the Times Square silver ball hits the bottom of its drop, the lights flash and the fireworks explode, there will no longer be a federal estate tax.

But the relief will be only temporary; the estate tax will return with a vengeance one short year later, reverting to its previous format with a $1 million exclusion and a 55 percent top marginal tax rate.

This odd state of affairs was created by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGGTRA). The Republican majority wanted to eliminate the estate tax, but they could not muster the 60 votes needed under Senate rules to affect tax revenues more than ten years out.

So EGGTRA increased exemptions over nine years, provided for an outright repeal of the estate tax in the 10th year, and a reinstatement of the estate tax under existing rules in the 11th year. The fiscal impact of EGGTRA was contained within a ten-year period.

No doubt, the Republican majority expected that the unlikely state of affairs would prompt a subsequent Congress to enact a permanent repeal.

## The Current State of the Estate Tax

The shift to a Democratic majority coupled with the recent economic dislocations that have made tax revenue scarce, have eliminated all hope of a permanent estate tax repeal. Many observers thought that we were quite close to a consensus reform. That reform would have simply frozen the current estate tax format featuring a $3.5 million exemption and a 45 percent top marginal tax rate.

However, that outcome has been held hostage by the continuing health care reform debate, which has virtually monopolized activity in Washington. Now, many are suggesting that estate tax reform will either occur late in the year, or perhaps not until next year, with a retroactive effective date to January 1, 2010.

The prevailing view is that retroactive tax provisions are constitutional, based on the 1994 U.S. Supreme Court decision in *U.S. v. Carlton* (512 U.S. 26) and a string of earlier cases. But those cases generally involved retroactive changes in tax rates, tax deductions, and so forth

Those tax features are arguably quite different from the retroactive imposition of a tax that had already been repealed under its own provisions. Accordingly, we will likely hear from the U.S. Supreme Court if estate tax reform takes that path.

Some observers are pessimistic about the situation and stress that the current shortage of tax revenue may prompt Congress to simply leave everything alone. That action will cause the estate tax to revert to its $1 million exemption and 55 percent top tax rate format.

However, others observers have recognized, and are starting to promote, that such a reversion may not produce as much revenue as some may think—on account of the state death tax credit.

Prior to the EGGTRA changes, the estate tax contained a prescribed maximum credit against the federal estate tax for estate and inheritance taxes levied by the states. Most of the states patterned their taxes to be equal to the federal state death tax credit, thereby costing estates nothing and creating an effective form of federal revenue sharing.

However, EGGTRA paid for its estate tax reductions, in part, with the conversion of the state death tax credit to a less costly estate tax deduction. Most states responded to the resulting loss of revenue by reinstituting their own taxes, thereby increasing the effective tax borne by estates.

However, a return to the previous federal estate tax law would include a return to the state death tax credit as it previously existed. Thus, even with the lower federal exemption and increased marginal tax rates, the additional tax revenue to the federal government may not be as much as many observers would expect.

That observation raises optimism that permanent federal estate tax reform is possible.

## The Pomeroy Bill

Also sitting quietly in the Senate is a bill introduced by Senator Pomeroy. That bill would eliminate the use of minority interest discounts in the estate tax valuation of interests in passive business entities.

Under this bill, minority interest discounts could be used only if the entity was engaged in an active business or operated real estate to such a level that it was deemed to be an active business for purposes of the passive activity rules.

However, even if the business entity met those requirements, the estate tax valuation would still have to be bifurcated with respect to any passive assets held by the entity. That ratable passive portion of the entity interest would have to be valued without adjusting for such valuation discounts.

While many observers believe that the Pomeroy bill stands little chance of passing today, many observers also believe that such a bill has a very good chance of passing eventually.

## Predictions

Trying to predict which legislation will pass is a nearly impossible endeavor. And doing so in these economic and political times is even harder than ever.

At this writing, Washington is almost totally absorbed with health care reform. And, it is becoming more likely that some form of health care reform legislation will be passed. According to a senior Senate staffer, that could come as early as Thanksgiving, or as late as some time in early 2010.

And, the Senate action on estate tax reform measures probably will not come about until the health care reform effort comes to a legislative conclusion.

There are a number of bills pending in both the House and the Senate that would take different approaches to estate tax reform. According to the same Senate staffer mentioned above, the most likely approaches to move forward would either (1) lock in the 2009 structure indefinitely or (2) increase the exemption to $5 million and reduce the top tax rate to as low as 35 percent. These changes may occur all at once or over a specified time.

The eventual outcome would likely be somewhere in between these two positions. However, the precise point is unpredictable due to budgetary concerns.

All of these uncertainties make estate planning quite challenging today. But that is nothing new, as we have been dealing with uncertainty and the unpredictability of future law ever since 2001. In doing so, a number of techniques have been developed over time that are likely to continue to be useful to the estate planner.

## Marital Deduction Formulas

One of the most apparent consequences of the recent state of constant change has been the effect on the drafting of marital deduction formulas. In 1981, the allowable marital deduction became unlimited and the exemption from estate tax began to increase. Since 1981, mainstream estate planning for a married couple has focused on doubling the exemption, as the exemption of the first of the couple to die is lost if the entire estate passes to the surviving spouse.

The typical mechanism for doubling the exemption is to structure the estate of the first spouse to die so that an amount precisely equal to the available exemption passes to a bypass (or credit shelter) trust for the benefit of the surviving spouse. And, the remainder of the estate passes to the spouse (either outright or in a qualified trust) and qualifies for the marital deduction.

Since the gift to the trust is equal to the exemption, and the gift to the spouse qualifies for the marital deduction, there is no tax in the first estate.

Although the trust is designed to benefit the surviving spouse, it is not treated as part of the survivor's estate. Therefore, the trust passes to the family at the survivor's death without estate tax, no matter how large the trust has grown.

Accordingly, the couple utilizes both exemptions, exempting up to $7 million from estate tax between them under today's exemption levels.

Since the exemption has changed over the years, and since the available exemption can be reduced by the use of lifetime gifts, it has always been impossible to accurately predict the exemption that will be available at a person's death. The solution has been to use a word formula in the will or living trust, designed in a way that one is assured the exactly correct share of the estate will pass to the trust.

There have been a variety of approaches to the design of the word formula, generally falling into the two broad categories of pecuniary bequests and fractional shares.

Each approach has its own advantages and shortcomings, and the selection of the most advantageous approach has always been case specific.

In making this case-specific determination, the most important factor has usually been the relative size of the two shares. However, with the exemption increasing dramatically over the last nine years, it has not been easy to predict which will be the larger share. This was the case except in the largest estates where the exemption is always a relatively small percentage of the estate.

## The Fractional Share Approach

Faced with such uncertainty, the fractional share approach is generally preferable. This conclusion is true not so much because it always produces the best result, but because it is the least likely to produce a bad result.

This conclusion was borne out by an informal poll of the members of the Estate & Gift Tax Committee at a recent meeting of the American College of Trust and Estate Counsel. The group's comments reflected a consistent trend toward the use of fractional share formulas.

Clearly, estate planning documents should be carefully reviewed to assure an appropriately chosen marital deduction formula clause is used.

A related point is whether or not to use the maximum deferral normally created by the marital deduction formulas in the smaller taxable estates. Ignoring for the moment the very real state death tax concerns discussed below, the increasing exemptions have meant that larger and larger shares of the estate of the first spouse to die will be held in trust for the lifetime of the survivor.

For example, let's say that the first spouse to die has an estate of $3 million. Every typical marital deduction formula will result in 100 percent of that estate passing to a bypass trust for the lifetime of the survivor.

However, if the survivor's separate estate is modest in size, the trust is unnecessary because, if all was left to the survivor, the survivor would still have a nontaxable estate. The administrative cost of managing the trust for the survivor's lifetime may well be wasted money.

But, perhaps more important, the family may be better off with the assets included in the survivor's estate—in order to get a full tax basis step-up to the assets' fair market value at the survivor's death.

Instead, the trust unnecessarily created at the first death leaves the assets with a basis equal to their fair market values at the first death, and an otherwise avoidable capital gains tax when they are sold after the death of the survivor. Accordingly, to focus solely on estate tax minimization can lead to unnecessary income taxation that can overcome any estate tax savings in some situations.

## State Death Taxes

As already mentioned, the elimination of the state death tax credit caused most of the states to quickly enact death taxes of their own. Most, but not all, have tied their taxes to the federal state death tax credit previously in effect.

Those states imposing taxes have established their own exemption levels, which vary considerably from state to state.

To add even more confusion, the estates of those who own property in more than one state can be subject to state death taxes in each state, and often with inconsistent results. For example, the state inheritance system in the author's home state of Oregon includes an exemption of only $1 million, with tax rates above that ranging from 5.6 to 16 percent.

To the north, Washington allows a $2 million exemption, but the tax rates are higher, ranging from 10 to 19 percent. To the south, California has no estate tax.

State death taxation is based upon jurisdiction, and it is fundamentally tied to a physical location (or situs). As a general statement, the state of a person's residence can tax the estate on all real property and tangible personal property located within the state, and on all intangible personal property wherever located.

Other states can tax the estate on all real property and tangible personal property located within their borders. However, the states have their own methods for determining the method of apportionment of taxes, and this can lead to inconsistent results.

## An Illustrative Example

A fairly simple example illustrates the surprising effects of this uncoordinated system of taxation. Let's say a California resident dies owning $3.5 million of assets with a California situs, and a $1 million vacation home in Oregon encumbered by $1 million of mortgage debt. With a $3.5 million net estate, there is no federal estate tax. There is no California death tax.

The Oregon vacation home gives Oregon taxing jurisdiction. The amount of the Oregon tax is determined by computing a tentative tax on the entire taxable estate of

$3.5 million applying Oregon tax rules, which include only a $1 million exemption.

The resulting tentative tax (i.e., $229,200) is then multiplied by a fraction reflecting the percentage of the gross estate located in Oregon, which is 22.22 percent ($1 million ÷ $4.5 million).

The result is an Oregon tax of $50,928, even though there is no real equity in the Oregon vacation home that creates the taxing jurisdiction.

This phenomenon is in no way limited to the Oregon-California combination. And, similarly unfair results can occur in any number of state combinations. This has resulted in an added dimension to modern estate planning—detailed planning for state taxation.

In the above example, the tax can easily be avoided if the situation is recognized before death. If the Oregon vacation home is owned by an LLC or an S Corporation, the ownership interest will be converted to intangible personal property. As such, it will have a California situs (state of residence of the owner), and Oregon will lose its taxing jurisdiction altogether.

Therefore, controlling the state of jurisdiction, by controlling the nature of the property interest, is now a key component of a well-designed estate plan.

Another common estate planning technique for married persons is to design the will or living trust to break the bypass trust down into smaller components, by carefully written will or trust provisions, so that different marital deduction elections can be made in the various states in which property may be taxable.

## Family Limited Partnerships and LLCs

Although the federal estate tax exemption has been rising steadily for the last nine years, the gift tax exemption has remained static at $1 million. That has made it important to leverage lifetime gifts whenever possible, in order to maximize their effectiveness.

Although family limited partnerships and LLCs have always been disliked by the Service, they have become rather common features of sophisticated estate plans. This is because they are very effective at leveraging the benefits of lifetime gifts by means of taking advantage of the valuation discounts that reflect the lack of control and lack of marketability of the ownership interests in the business entity.

For example, let's say a married couple transfers $6 million of assets to a limited partnership or LLC, and then gifts 50 percent of the ownership interests to their children. Although the 50 percent interests carry $3 million of inherent asset value to the children, they lack control and marketability, and they are customarily valued by reference to a valuation discount.

The magnitude of the valuation discount depends on a number of factors, such as the nature of the assets held by the entity, its operating and distribution history, and so on. However, valuation discounts ranging from 20 to 50 percent are considered common.

At a 33 percent discount level, the gifted 50 percent interests will be valued at $2 million. That amount is fully sheltered by the couple's two gift tax exemptions (their annual gift exclusions may also be available).

Further, their retained 50 percent interest should obtain a similar discount in their estates. Thus, $2 million of value slips through the cracks of the transfer tax system.

The Service has achieved an impressive string of judicial victories using Section 2036 of the Internal Revenue Code to attack such techniques. Under Section 2036, the entity can be disregarded, and the valuation discounts may be lost entirely, if the parents (1) explicitly or implicitly retained the right to control or (2) continue to receive the income from the transferred assets.

This Section 2036 attack has led many observers to incorrectly believe that family limited partnerships and LLCs are no longer viable tax planning strategies.

On closer inspection, the Service judicial victories have all come in very similar patterns, cases that are described by estate planners as having "bad facts." In most of these cases, the estate planning was prepared just before death, there were no reasons for the formation of the entity other than estate tax minimization, the parent received all of the income whenever it was needed, substantially all of the parent's assets were transferred to the entity, legal formalities were not followed, and similar factors.

Careful attention to these matters, and more appropriate design of the entity, will go a long way to defending such a Service attack. In fact, the Service has been largely unsuccessful when it has pushed outside this narrow box, and taxpayer victories are starting to be reported.

Consequently, family limited partnerships and LLCs are still very viable estate planning techniques. However, more care must go into their design and operation in order to withstand such Service challenges.

## Sales to Grantor Trusts

Worry that the Pomeroy bill, or a future similar bill, may become law and eliminate valuation discounts has focused attention on transferring family limited partnerships and LLCs out of one's estate as quickly as possible to lock in the valuation discounts. That strategy has placed greater emphasis on leveraging the $1 million gift tax exemption, and sales to grantor trusts have become a very popular technique.

This technique starts by creating an irrevocable trust for the benefit of the family. Transfers to the trust are gifts, and utilize some or all of the parent's $1 million gift tax exemption.

The trust can be designed in almost any way desired to assure long-term management of the trust assets for the benefit of the family, protection from creditors, and other benefits, so long as the parent does not reserve any powers that would cause the trust to be included in his or her estate. Thus, the transfers are completed gifts, and are no longer subject to estate tax.

The irrevocable trust is designed to carry an additional special provision that will cause it to be considered a "grantor trust" under the income tax rules. There are several options here. But, for example, one of the more commonly used characteristics is to include a "swap out" provision that allows the parent to take assets out of the trust if other assets having an equivalent value are substituted for them.

The mere existence of such a power, whether it is ever exercised or not, will cause the trust to be a grantor trust. However, since the substitution power is premised on equivalent value, it does not cause the trust to be included in the parent's estate.

As a grantor trust, the income tax rules deem the parent to be the owner of the assets inside the trust. Consequently, all income realized by the grantor trust is taxable to the parent, not the trust or the family. That has the added advantage of serving as an indirect gift to the family.

However, since the result is mandated by the income tax rules, the seemingly clear economic benefit to the family is not treated as a taxable gift, no matter how large the magnitude.

Once the grantor trust has been created and funded (see below for funding requirements), and a reasonable length of time has passed to separate the transaction, the parent can sell part or all of his or her family limited partnership or LLC to the grantor trust in exchange for a note.

The sales price would be the fair market value of the transferred interest, which would be determined using minority interest valuation discounts.

Since the grantor trust rules provide that the parent is treated as the owner of the trust assets, transactions between the grantor and the trust are generally not taxable events. Consequently, the parent is treated, for income tax purposes, as having sold the interest to himself or herself, and no taxable gain is recognized.

Similarly, all interest paid by the grantor trust is deemed to constitute payments made to the parent by the parent, and is not recognized as income. Of course, the income generated by the family limited partnership or LLC is taxable income, and is taxed to the parent under the grantor trust rules.

However, the grantor trust rules apply only for income tax purposes, and the grantor trust is still recognized as a separate entity for gift and estate tax purposes.

As a result, the parent ceases to be treated as the owner of the family limited partnership or LLC interest immediately upon the sale. And, the note given by the grantor trust becomes the grantor's asset, includible in the estate.

As payments are made, the cash received becomes part of the grantor's estate, while the note declines in value by the amount of the principal paid.

At the parent's death, the estate includes only the remaining balance due on the note, not the family limited partnership or LLC interest. Also, the trust ceases to be a grantor trust, and continues for the remainder of its term as a separate taxpayer.

Therefore, the essence of the technique is to freeze the value of the estate at (1) the minority interest value of the family limited partnership or LLC interest plus (2) the "interest" paid less the income taxes paid on the income pass-throughs.

## Technical Considerations of the Grantor Trust

There are a few technical details that should be addressed:

1. **Note Terms**

   The terms of the note are very flexible. The interest rate must be only high enough to avoid a deemed gift on a below-market loan, but it can be as high as the rate that would be charged in the commercial marketplace.

   The term of the note is entirely flexible, and it is theoretically feasible to design the note so it is self-cancelling at the parent's death.

2. **Note Payments**

   The grantor trust typically uses the cash distributions from the family limited partnership or LLC interest to fund the payments on the note.

   Thus, the economic essence of the transaction is that the parent essentially reserves the future distributions from the transferred interest for a specific period of time, after which all future distributions stay with the grantor trust and benefit the family beneficiaries.

3. **Seed Gift**

   If the grantor trust has no assets at the time that the family limited partnership or LLC interest has sold to it, it is very possible that the Service could successfully argue that the transaction is not a sale at all. Rather, the Service could argue that the transaction was merely a series of intergenerational gifts that were made over the term of the note.

   To avoid this, most careful estate planners follow informal guidance from the Service that 10 percent equity in the grantor trust would be sufficient to avoid such an argument.

   Consequently, the grantor trust should be funded with a seed gift having a value of at least 10 percent of the value of the family limited partnership or the LLC interest that is to be sold to it. The seed gift to the grantor trust can be (1) cash, (2) other assets, or (3) even a smaller interest in the same family limited partnership or LLC.

   If the seed gift is cash or other assets, then these assets:

   1. stay in the grantor trust and
   2. should not be used as a down payment on the purchase of the family limited partnership or LLC interest.

   Also, note that the seed gift will likely be a taxable gift, requiring the filing of a gift tax return and the use of some of the state tax exemption of the grantor (and, of the spouse, if a gift split).

4. **Basis**

   There are complex, and largely unanswered theoretical questions about how the grantor trust determines its basis in the family limited partnership or LLC acquired from the parent. Estate planners disagree about the proper answer, and it will likely have to be resolved over time.

   The apparent alternative outcomes are a carryover of the parent's basis in the interest, a cost basis determined by the amounts paid on the purchase price by the grantor trust, and a step-up to fair market value at the death of the parent.

5. **Turning Off Grantor Trust Status**

   The grantor trust can be designed so that the grantor can irrevocably relinquish the powers that cause it to be a grantor trust. That creates additional options after the note has been paid.

   The trust can remain a grantor trust, with the parent paying income tax on the income that passes through to the trust, or the powers can be released and the income will thereafter become taxable to the trust and/or its beneficiaries.

## Sale to the Grantor Trust Summary

A sale of a family limited partnership or LLC interest to a grantor trust is a very sophisticated transaction, and implementation requires thorough analysis and planning.

The expected gift and estate tax results are highly dependant upon the valuation of the family limited partnership or LLC interest, and a valuation performed by an experienced valuation analyst is important.

Properly designed, the sale to the grantor trust will permanently remove the family limited partnership or LLC interest from the parent's estate at its discounted minority interest valuation, often within the allowable gift amounts that can be sheltered by the gift tax exemption.

The "sale" does not cause any income tax consequences. And, most importantly, the benefits of the valuation discounts can be realized today, even if the law changes later to eliminate the use of those valuation discounts.

## Summary and Conclusions

The changes made to the gift and estate tax law were intended to simplify estate planning for the vast majority of Americans. Predictions were that, within a few years after passage, the estate tax exemptions would increase to the point where only the very wealthiest of American families, the top 1 percent, would ever face an estate tax liability.

Things haven't really turned out that way. We now have a more complex system than ever imagined and the goal posts keep changing all the time.

This situation has made estate planning very challenging, and it has forced us to devise flexible, but more complex, techniques to respond to the constantly changing environment. It is now essential that the most skilled estate planners possible be used as advisers.

That has undoubtedly made the process more expensive than before, but the rewards of careful planning may be greater than ever before.

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