Estate Planning Opportunities in 2012 and Beyond

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***Abstract*— The U.S. is in an unprecedented estate planning conundrum that can bifurcate towards either elimination of estate taxes or reinstating exclusion amounts that are nearly 80% lower than the current exclusion amount and estate tax rates that are 20% to 25% higher. This paper discusses the current estate tax climate along with potential outcomes for 2013. We conclude with estate planning strategies given these potential outcomes.**

***Index Terms*—Estate Planning; EGTRRA; Estate Tax; Tax Planning**

I. Introduction

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was one of the largest pieces of legislation to impact tax changes in the last 50 years. Numerous academic articles and books have been written specifically addressing tax changes coming from this act and strategies to take advantage of the changes. EGTRRA was set to expire in 2010 but Congress passed a two year extension under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act). This extension allowed for several estate tax oddities, and moving into 2013, several estate tax uncertainties. So where does this leave those trying to plan their estate in the coming years?

To answer this question we must first start at the beginning by addressing those segments of the EGTRRA that are likely to be extended and those that might not. Initially EGTRRA was enacted as part of the Bush tax cuts, as one of the most sweeping pieces of tax legislation in recent history. Estate tax rates were reduced between the years of 2002 and 2009 from a maximum rate of 60% to a maximum rate of 45% (Noto, 2006). The exclusion amounts have also been impacted as the exclusion grew from $675,000 in 2001 to $3.5 million in 2009 and ultimately a repeal of estate taxes in 2010. In 2011, without a patch or new act EGGTRA would sunset back to estate tax levels under the provisions of the Taxpayer Relief Act of 1997, where the exclusion amount would fall to $1 million and the maximum rate would increase to 60%1. Given the state of the economy in 2010/2011 Congress chose to act to stimulate the economy rather than take a regressive tax strategy. however neither party was willing to make a long term compromise so a temporary two year extension was enacted in December 2010 (Herszenhorn & Sgtolberg, 2010).

Under the Tax Relief Act of 2010 which extended EGTRRA for two years, the maximum estate tax rate was set at 35% with an exclusion of $5 million in 2011 and $5.12 million in 2012. Secondly, even though estate taxes were eliminated for the year 2010, a new rule for carry-over basis applied instead of the step-up in basis that was typical. This carry-over basis meant that inherited property would keep the same basis as though it was sold by the deceased owner-receiving the lesser of the decedent's basis or fair market value on date of death. This created a larger than normal gain and thus tax liability for those selling decedents' assets from 2010. Another addition of the Tax Relief act was to provide portability of unused spousal estate tax exemptions. The portability allowed the surviving spouse to reduce their estate tax liability by any unused portion of the deceased spouse. Lastly, gift tax and generation skipping transfer tax (GST) were linked with estate taxes in 1976 but changed some during EGTRRA and are set at 35% for the years 2011 and 2012. In the remainder of this paper we will discuss the relevant literature on estate planning opportunities, discuss the uncertainties in estate planning, present the opportunities in estate taxation given the uncertainties in the coming years, and conclude with the implications and limitations of this study.

II. Analysis

A. Uncertainties Given Current Economic State

Any changes that will take place to bridge the gap left after the two year extension of EGTRRA will likely take place in an election year when little legislation is typically enacted, let alone a complex and debated tax policy. Throughout 2011 several bills were introduced to eliminate estate taxes ("End Tax Uncertainty Act of 2011," 2011; "Permanently Repeal the Estate Tax Act of 2011," 2011) and rumors that the Super

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[1] The 60% includes the highest marginal rate of 55% and the 5% surtax that was repealed but would be reinstated.

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Committee would propose permanent tax levels set to the 2009 rates. None of these bills have left the ground and with a divided congress it is unlikely any major legislation will pass in 2012 beyond a potential extension or patch to the Tax Relief Act. The Tax Relief Act has been estimated to negatively impact revenue from between $68 billion and $12 billion (Scherer, 2010). This leaves Congress with three likely options to bridge the gap in 2013 (1.) repeal the estate tax, (2.) do nothing, (3.) extend the current provisions or a similar bill.

Congress could repeal federal estate taxes all together as they represent a very marginal percentage of federal tax revenue. A continued Republican majority would be the only case in which this is a likely outcome, but many Republicans seem to be interested in repealing the estate tax. If Congress decides to do nothing then estate tax rates will revert back to 55% plus a 5% surtax for large estates and a maximum $1 million exclusion amount. Given the state of political affairs moving through 2012 this might be a likely outcome. If Congress does nothing then having an appropriate estate planning strategy will become critically important for a much larger percentage of these estates. The last option would be for Congress to pass an extension to the Tax Relief Act or pass a bill that allows House Republicans and Democrats to meet in the middle.

B. Planning Opportunities Given Estate Tax Uncertainties

Given the uncertainties surrounding estate, gift, and GST in 2013 it is very important to consider planning strategies that will take advantage of current, historically low estate tax rates while maintaining flexibility going forward. Tax strategies, like any investment strategy, need to consider an allocation strategy given the uncertainty of future states. With so much uncertainty going forward, an appropriate plan would be a strategy that takes advantage of both rates today and potentially favorable rates going forward. A few strategies to consider are:

1) Take advantage of the $5.12 million gift/GST exclusion in 2012. This requires transferring assets in trust or in kind to any individual or charity. For couples this exclusion doubles and both spouses are still allowed $13,000 annual gift-tax exemptions each. The downside to this strategy is loss of control of these assets once gifted. Without the proper preparation, children might not be prepared to receive gifts of this size. One way to retain some control while still transferring these assets would be to transfer these assets in the form of a family limited partnership where the giver is the general partner with limited ownership. If the asset transferred is a business with few owners it is even possible to donate the assets at a discount due to a lack of marketability.

2) A riskier position would be to take advantage of the 35% gift tax rate in 2012. If you assume that Congress will allow the gift tax rate to return to 55% (plus the potential 5% surcharge), then gifting assets today at the preferential 35% rate might make sense. The risk with this strategy would be if estate taxes are eliminated or the exclusion amount increases.

3) Assuming the portability provision of the Tax Relief Act expires, it is important to consider a credit shelter trust. A credit shelter trust allows one spouse to use their entire exemption amount upon death by passing the maximum amount of exempted assets into a trust to be transferred to children or someone other than their spouse. The spouse still retains rights to use these assets and the right to any income generated during his/her lifetime. This is a great way to transfer ownership of an expensive home to the children while allowing the surviving spouse to reside in that home.

4) Given the current state of the economy and the current interest rate environment, an Intentionally Defective Grantor Trust (IDGT) could be used to freeze assets that have been depressed in value, getting them out of the donor's estate. Essentially an asset is sold to the trust in exchange for an interest only note. The rate at which the note is issued is the applicable federal rate which is currently between 1% and 3% depending on the duration of the note. As long as the asset in the trust appreciates at a rate greater than the interest charges on the note then the remainder will stay in the trust for the beneficiaries. This strategy is not for a conservative planner since statute allowances are not as clear as they might be in other similar trusts such as a granter retained annuity trust (GRAT). Strategies such as these have come under scrutiny by the Obama administration and if estate tax laws are changed going forward it is likely that the effectiveness of these trusts might be greatly diminished.

5) An appropriate qualified disclaimer on any trust will allow the beneficiaries to reject any assets that pass to them and can allow for major flexibility given the uncertainty of future estate tax rates. A qualified disclaimer will work well if estate tax rates revert back to estate tax levels under the provisions of the Taxpayer Relief Act of 1997. In certain situations assets could be disclaimed and ultimately passed on to a second generation beneficiary.

III. CONCLUSION

It is impossible to know with certainty what 2013 will bring in the way of estate tax legislation. Given the size of the growing national debt and the fact that 2012 is an election year, many are saying that Congress will just allow the Tax Relief Act to revert to 2001 estate tax levels. This will be greatly dependent on which party maintains control going forward. One thing is certain, having an appropriate estate plan is crucial to reducing estate taxes in the coming years. The best plans are designed to take advantage of the low rates and high exemptions offered in 2012 while maintaining flexibility in the future. Similar to allocation of investment assets, it is important to consider a strategy of tax allocation.

This requires consideration of using all or part of the 2012 exclusion for those who anticipate a reduction of the exclusion amount after 2012. There are a number of strategies and trusts that can be used to retain use and control of assets while taking advantage of exclusion amounts today. The tradeoff with any trust is going to be ability to control one's assets while living verses tax advantages of removing assets from one's estate. Several of these strategies are outlined in this paper but some of these strategies are coming under scrutiny by the Obama administration and might not be available after 2012. When considering any estate strategy it is also important to consider non-tax consequences such as the purpose of the funds, likelihood the beneficiary will effectively manage large increases in wealth, and the donor's ability to maintain their current lifestyle after the gift. Even though maximum reduction of estate taxes is one of the primary benefits of appropriate planning it is always important to prevent the proverbial tax tail from wagging the dog.

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