

LEGAL ALERT

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ESTATE PLANNING UPDATE

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Now an annual event, this letter describes some of the more significant events that have occurred in the past year with regard to estate planning.

1. Gift Tax. The federal gift tax annual exclusion is now \$11,000 per donee (up from \$10,000 per donee, per year). To qualify, the gift must still be of a *present* interest (i.e., generally not to a Trust). The concept of a *present* interest is receiving lots of attention in the Tax Court these days, and a *present* interest may not be that obvious.
2. IRC §529. This Tax Code section continues as the nationwide rage. 45 states have adopted "§529 plans." Taxpayers can *prefund*, gift tax-free, up to five (5) years of contributions, or \$55,000 per person, into a §529 account. If the money is used for *qualified higher education expenses* incurred by the beneficiary of the §529 account, the distributed earnings on the account are income tax free. The account owner can always change the beneficiary. More importantly if, with hindsight, it was determined to be a mistake to transfer that magnitude of wealth to a §529 account, the taxpayer can revoke the transfer and regain control of the money (and earnings), but the withdrawal would then be subject to a ten (10%) percent tax as well as *ordinary* income taxation. There are still a few *bugs* to be worked out with Michigan's §529 plan. For example, a Trustee cannot hold title to a §529 account. In the years to come, it is expected that §529 accounts will continue to be very popular devices to: (i) make lifetime gifts; (ii) "bunch" federal gift tax annual exclusion of \$11,000 a year, e.g., \$55,000 gift at one time, gift tax-free; (iii) remove assets away from the taxpayer's estate; (iv) provide an income tax free way to pay for education; and (v) retain the right to revoke the gift, which cannot be accomplished with any other type of gifted asset.
3. Estate Tax. Congress tantalized us last year with the prospect of the ultimate repeal of the federal estate tax. Last year's Tax Act provides substantially larger exemption amounts that are *phased-in* until calendar year 2009. This year and for calendar year 2003, the exempt amount is \$1.0 million per taxpayer; it then increases to \$1.5 million per taxpayer for the following two (2) years; then \$2.0 million for three years. The federal estate tax is scheduled to be repealed in calendar year 2010. Yet the estate tax comes roaring back in calendar year 2011 with the exemption from federal estate taxation pegged at \$1 million per taxpayer. As a result of these phase-in rules, it is impossible to plan too far into the future. Most cynics bet that the phase-in in the estate tax exemption will stop in calendar year 2007 (\$2 million exemption per taxpayer; a flat 45% estate tax on any excess) due to the current government revenue deficit.
4. Planning. Trying to plan in this ever-changing environment is difficult. You should frequently review your estate planning instruments to confirm that they still *make sense* in light of these evolving federal estate and gift tax law changes. For example, many existing Trust formulas prepared in the 1980's and

1990's use what is known as a *reduce to zero* federal estate tax marital deduction formula. Under that formula, the maximum amount that would be sheltered from federal estate tax by the taxpayer's then available tax credit causes those protected assets to be transferred into the *family* or *credit shelter* trust. Any excess amount owned by the decedent is transferred to the surviving spouse, either outright, or through a *marital deduction* trust. Assume, for example, that a taxpayer worth \$1.0 million in 1993 used a *reduce to zero* estate planning Trust formula. At that time, the maximum tax credit available to that taxpayer was \$600,000. That formula would have resulted in \$600,000 transferred to the *credit shelter* trust and \$400,000 transferred outright to his surviving spouse. With the change in tax rules effective as of January 1 of this year, that same taxpayer would have his full \$1,000,000 transferred to the *credit shelter* trust on his death. No assets would transfer to his surviving spouse. While surviving spouse is often a beneficiary of the *credit shelter* trust, but this is not always the case, and many restrictions can be imposed on the survivor's access to that wealth held in the *credit shelter* trust, e.g., forfeiture of rights upon remarriage. Consequently, so as to avoid an inadvertent "disinheritance" of your surviving spouse, it is important that you take a close look at your estate planning distribution formula and ask yourself the question: "Does this formula still make sense?"

5. Gift Tax Delusion. With all the discussion about the estate tax credit *phase-in*, do not be deluded into assuming the old tax rules apply to the present tax planning environment. For example, before calendar year 2002, the federal estate and gift tax laws were *unified*. Each taxpayer was given a credit; that credit could be applied toward lifetime gift taxes or estate taxes. Since most people were reluctant to make sizeable lifetime gifts for fear of needing that transferred wealth later in life, they did not use their unified tax credit to cover gift taxes, and instead they *hoarded* their tax credit and applied it to estate taxes at their death. What was easy was that the credit covered the same amount of taxes. One not so subtle distinction arising from the 2001 Tax Act was that beginning in January of this year, the federal estate and gift tax laws were *divorced*. Presently, and through 2009, a person may make lifetime gifts of \$1 million and use his or her credit to shelter the gift tax on that transfer of wealth. Yet beginning in calendar year 2004, the federal estate tax exemption will shelter \$1.5 million in the transfer of wealth at death, \$2 million beginning in calendar year 2006 at death, and \$3.5 million of the transfer of wealth at death in calendar year 2009, while the federal gift tax credit remains flat, covering \$1.0 million of gifts during lifetime.

Beginning in calendar year 2004, if a person on his death bed wants to gift his full estate of \$1.5 million, he could not do so gift tax-free. He could gift \$1 million gift tax-free, but he would have to hold onto his remaining \$500,000 until death and then pass the balance of wealth federal estate tax-free to escape any transfer tax. However, if he, or someone on his behalf, chooses to make a deathbed gift of \$1.5 million, he will incur a federal gift tax of about \$225,000, a tax that they could have avoided had they held the \$500,000 until his death. The worry that many planners have is that while parents may be fully aware of this *divorce* in the transfer tax laws, their children who hold Durable Powers of Attorney may not. Consequently, a child when confronted with their parent's imminent death, but who holds a Durable Power of Attorney, might labor under the erroneous assumption that if they transfer all of their parent's assets during the parent's lifetime and before death, there would be no federal estate *and* no federal gift tax.

6. QPRT. A Qualified Personal Residence Trust (QPRT) is still a popular estate planning device, especially with continued appreciation in northwestern Michigan real property values. While the stock market collapses, real property values seems to "hold" their own. A QPRT *shifts* the appreciation in a principal dwelling to another person, usually children or grandchildren, at little or no transfer tax cost. While a nominal gift tax is incurred at the time that the QPRT is established, the taxpayer's gift tax credit is *used* to cover that gift tax so no money changes hands with the IRS. For homes on larger lakes, e.g., Torch Lake, it is not uncommon to experience an 8% to 12% annual property value. If these are old family cottages that are intended to pass from one generation to the next, it is irritating to pay an estate tax on

the appreciation in the cottage when it does not generate income, and it is used only as a summer retreat by family members. A QPRT provides the solution to this problem. There may be less incentive to pursue a QPRT with the possible repeal of the federal estate tax looming in calendar year 2010. However, cynics do not believe that the federal estate tax will go completely away. If the ultimate objective is to transfer a home or cottage to your children to be held in the family for generations, then a QPRT still makes sense. A QPRT: (i) removes the value of the cottage and all future appreciation from your taxable estate; (ii) enables the owners to still enjoy the use of the cottage for several years.

7. GRAT. Sam Walton and his family are known for a lot of things including their incredibly successful WalMarts. Last year they helped other taxpayers by successfully litigating in the federal Tax Court. A Grantor Retained Annuity Trust (GRAT) is principally used by a taxpayer who wants to give away appreciation in some of her assets, but she does not want to give away the entire asset, or incur too much of a gift tax. While assets are transferred into an irrevocable Trust (the GRAT), the transferor continues to receive a stream of annuity payments from that GRAT for a specified number of years. At the end of the GRAT's term, e.g., 10 years, any remaining assets held in the GRAT are passed on to children, grandchildren, or other named trust beneficiaries. If the assets inside the GRAT grow at a rate more rapid than the assumed rate of interest on the date that the GRAT was funded, that asset appreciation is shifted to the designated beneficiaries at the end of the GRAT's term, gift tax free. For example, assume that at the time that the GRAT was funded the federal applicable interest rate was 7%; yet the assets that were transferred into the GRAT grow at the rate of 10% a year. Since the GRAT's assets grew more rapidly than the presumed federal interest rate, that *spread* in interest rates represents wealth that passes to the "end" beneficiaries, gift tax-free. If the assets "inside" the GRAT actually grow at the 7% interest rate, following the example, no transfer of wealth results.

So why is *Walton* important? Sam Walton's sister transferred several millions of dollars of WalMart stock to a GRAT which she intended to "zero out." By *zeroing out*, she specified that the GRAT was for a specific, e.g., 10 year term, which was calculated to result in no (\$0.00) transfer of wealth to the designated "end" beneficiary. To obtain this computational result, Ms. Walton specified that in the event that she died during that 10 years, she wanted the remaining GRAT annuity payments paid to her probate estate. As a result, she asserted that no gift was made to the designated beneficiaries when the GRAT was funded, hence no gift tax was owed. The IRS challenged her position. The Tax Court ruled the IRS was wrong. Consequently, it is now possible to have a *zeroed out* GRAT, with no gift tax exposure to the donor. In the event that good fortune smiles on a family and the GRAT's assets grow in value during the GRAT term greater than the interest rate the funded-GRAT presumed, that future growth passes to the "end" beneficiaries, but with no gift tax. If the rate of actual appreciation remains the same as the federal "rate of the month" presumed, the donor is not out of pocket anything. The IRS did not appeal the Tax Court's decision. The *zeroed out* gift tax-free GRAT wealth shifting technique is now expressly "endorsed," which is helpful at a time when new lifetime limits are imposed on the amount that can be given away, gift tax free.

8. Entireties Ownership. Michigan, as well as many other common law states, specifically recognizes the concept of *entireties* ownership by a husband and wife. It is a unique form of ownership. The significance of *entireties* ownership is that if a judgment is entered against one spouse, the *entireties* property cannot be attacked or divided to satisfy the judgment held against the one spouse. *Entireties* ownership has been authorized in Michigan since it first became a state. But the most recent legislative description of what assets can be held by the *entireties* is a stale 1913 statute. Obviously a lot has changed since 1913. Many investment opportunities now exist that were not even dreamed of in 1913. As such, there is confusion [translated: Debate] as to whether some investments, e.g., mutual funds, can be legally held by the *entireties* or only as "joint tenants with full rights of survivorship," which does not provide complete creditor protection.

Of keen interest, but not yet passed, is a proposed amendment to Michigan's Limited Liability Company statute that was targeted for May of this year. The amendment, if passed, will permit a husband and wife to own their Limited Liability Company units by the *entireties*. The significance of this potential statutory amendment is that all those questionable assets where there is still some debate whether the asset can technically be owned by the *entireties*, e.g., common stock; mutual funds; hedge funds; etc., can be owned by a Limited Liability Company, the units of which are owned by a husband and wife by the *entireties*. An LLC will thus enable a married couple to shelter literally all of their assets from the creditor claims of one spouse. This amendment has not yet passed, but the amendment appears to be a probability, unless Lansing's "creditor's lobby" wakes up.

9. IRA Distributions. The IRS surprised us once again, a year after it stunned us with *new minimum distribution* rules, by coming up with final Regulations on minimum distributions from qualified plans and IRAs. Suffice it to say that all these rules are extraordinarily complex. These new rules are generally oriented to help taxpayers. Now taxpayers do not have to irrevocably choose their beneficiary by age 70-1/2 years. Moreover, they can, in general, leave more assets inside their IRA to grow on a tax deferred basis for a much longer period. A couple of key points to keep in mind. (i) Always use a *named beneficiary*. Do not rely on Plan or IRA *default* rules that specify to whom benefits flow if you do not identify a beneficiary, e.g., to your probate estate or your estate's Personal Representative. Default rules usually will ensure the *fastest* payout of these benefits, thus *bunching* more taxable income into a single tax year or a much shorter period of time. (ii) Whenever possible, refer to the creation of *separate shares*, if there are multiple IRA beneficiaries, in the beneficiary designation form. This enables the beneficiary to "manage" his or her own separate share, not only as it relates to investments, but also permits each beneficiary to independently choose to withdraw the least amount of taxable income (which, in turn, permits the longest accumulation of income inside his or her share of the IRA, tax deferred.) *Separate shares* and the named beneficiaries must be identified in the beneficiary designation form. You cannot direct IRAs to be paid to a Trust and then rely on a Trust (for your children, for example) to meet the required *separate share* directive.
10. Joint Trust/Tax Basis. Recently there were two (2) seemingly highly favorable IRS rulings with regard to income tax basis. Briefly, an asset's income tax basis enjoys a *step up* to the asset's full fair market value when that asset is included in the taxable estate of the owner of the asset. For example, if my father bought a piece of property for \$50,000 and it is now worth \$100,000, and my father bequeaths that property to me, if that asset is included in my father's estate for estate tax computation purposes, that asset will receive a *step up* in income tax basis from \$50,000 to \$100,000. Once I inherit that asset, if I promptly sell the asset for its fair market value of \$100,000, I will incur no capital gain tax. There is one notable exception in the Tax Code to this *step up in basis* rule. Back to the prior example, assume my parents hold title to an asset worth \$100,000, which my father owns jointly with my mother. My father dies. My mother is automatically the sole owner of the asset. Since my mother does not want any assert managerial responsibility, she immediately sells the asset and she does so for \$100,000, the asset's fair market value. By virtue of a special Tax Code section, there is only a 50% *step up* in income tax basis on my father's death. That means that my mother's tax basis in the asset, when she sells it, will be \$75,000 and she will thus have to pay a capital gain of about 24% (combined state and federal income taxes) on the other \$25,000 that she receives upon its sale. So, if there are some assets that a surviving spouse definitely will not want to hold onto, because it carries too much responsibility to manage and maintain, e.g., the infamous deer hunting camp a widow inherits, that asset should normally be held exclusively in the name of only one spouse, so it will receive a full income tax basis *step-up* upon the owner's death.

The new surprise is that the IRS seems to have endorsed (through private letter rulings which are not supposed to be precedential, but why do they publish them if they do not want us to follow them?) a *full step up* in income tax basis using a Joint Trust. Under the described Joint Trust arrangement, any assets held in that Joint Trust will receive a full income tax basis *step up* (including the

assets that were contributed to the Joint Trust by the surviving spouse), if the Trust becomes irrevocable on the death of one spouse. The upshot of the private letter rulings are that the conventional two (2) Trust estate planning techniques of the past used by a husband and wife need to be seriously re-examined, not only because there is a much larger exemption available on the surviving spouse's death to cover any potential estate tax liabilities, but also because of this income tax basis treatment, which enables a husband and wife to gain a *full step up* in tax basis of *all* of their assets simply by using a Joint Trust mechanism.

SUMMARY

These are challenging times for people who want to plan. The objective of any good estate plan is to leave a legacy of relationships and fond memories, rather than a legacy of conflict and tax liability. Taxes are an important consideration since the federal estate tax, at least today, is a maximum 50%. However, what is most important is that your estate planning wishes are carried out. That means that through planning, the right people receive the right amount of property at the right time, and that no undue hardships are imposed upon your heirs caused by your death or caused by the assets or debts that you leave behind. By virtue of these rapid changes in the law (both at the state and federal level) it is wise to review your estate planning documents every couple of years, just to make sure that your plan as written still makes sense to you, and that your personal planning objectives will be met.

If you have any questions, about these topics, please feel free to contact George Bearup or any of the attorneys listed below.

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