Cover Story

Confused by Tax Reforms? Follow these 10 key rules for better estate planning in Tennessee

By Dan W. Holbrook

Tax Reform 2001 gradually raises the federal estate tax exemptions while reducing the top rates. Unless Congress intervenes, the federal estate tax disappears completely in calendar year 2010, only to revive like the phoenix (or perhaps a weed) in 2011. The federal gift tax remains, with a fixed $1 million exemption. The Tennessee inheritance tax exemption increases each year until 2006, but will always be lower than the federal exemption.1 In the midst of such uncertainty, consider these Top 10 rules for estate planning in Tennessee.

Rule #10. Continue to allocate the maximum to Credit Shelter Trusts for federal purposes. A Credit Shelter Trust at the death of the first spouse remains the primary tool of basic federal estate tax planning, to ensure that both spouses' exemptions are utilized. Formula language common under current law remains generally acceptable. A Credit Shelter Trust, perhaps in conjunction with an irrevocable trust for life insurance, can eliminate federal estate tax for most estates.

Exception #10-A. Discontinue using Credit Shelter Trusts if the federal exemption exceeds the taxable estate. The federal exemption rises to $1 million in 2002, $1.5 million in 2004, $2 million in 2006, and $3.5 million in 2009. If the federal exemption rises above the combined net worth of a couple, then federal taxes may be ignored, and simple wills substituted. On the other hand, Tennessee's inheritance tax will likely remain in effect, with an exemption increasing from $700,000 in 2002 to $1 million by 2006. So for a married couple whose combined taxable estate is more than the single Tennessee exemption, a Credit Shelter Trust at the first death may still be desirable to reduce Tennessee death taxes.

Exception #10-B. Limit or amend Credit Shelter Trusts where the increasing exemption distorts the basic estate plan. With a typical formula clause, the increasing exemption allocates more to the credit shelter amount, at the expense of the marital share. Many Credit Shelter Trusts designed for the benefit of multiple family members may not adequately provide for the surviving spouse. The surviving spouse might also feel a loss of control by having so much in trust, and feel pressure to take an elective share. The point is to review the effect of the increasing exemptions so that the Will provides adequately for the spouse no matter which year's exemption governs. Similarly, if the formula clause allocates the excess over the exemption to charity, the testator might amend the formula to guarantee some minimum to charity.

Rule #9. Shoot the "Tennessee gap." The scheduled rise in the Tennessee death tax exemption lags the rise in the federal exemption, as shown on the chart below, creating a "Tennessee gap" after 2001. A fully funded Credit Shelter Trust for federal estate tax purposes will result in some Tennessee death tax on the first death. There are three alternatives:

> **(1) Full-funding.** This is the default in most existing wills, to allocate the full federal exemption to the Credit Shelter Trust at the first death. [Drafting point: a full-funding formula should cross-reference both the credit for state death taxes, which is phased

out from 2002 through 2004, and the deduction for state death taxes, effective in 2005.] Since the Tennessee exemption will be less than the federal after 2001, this will trigger some Tennessee tax at the first death. This may not be bad, since the Tennessee inheritance tax is unlikely to be repealed, and may even be increased, so the assets would be taxed at the second death in Tennessee anyway, perhaps at higher rates. The chart below shows the Tennessee tax on a fully-funded Credit Shelter Trust.

(2) Super-funding. By deleting any reference to the state death tax credit (or deduction after 2004), the formula clause could allocate even more than the federal exemption to the Credit Shelter Trust, without incurring any federal estate tax. In an odd interplay between the federal and the state death taxes, involving the state death tax credit (or deduction), the federal estate tax begins not at the federal exemption amount, but at a number somewhat higher. Thus, up to the point where the federal estate tax kicks in, it may be advisable to pay some Tennessee death tax at lower rates in order to remove more assets from federal estate taxation later at much higher rates. The chart below shows the Tennessee tax on a "super-funded" Credit Shelter Trust. You would choose super-funding if you were willing to pay some Tennessee tax at the first death and if you assumed that the estate of the second spouse to die would be exposed to federal estate tax anyway, either because of death prior to 2010 or because repeal will never occur.

(3) Zero-tax funding. The Tennessee gap can be closed in one of two ways. First, the Credit Shelter Trust could be drafted in the form of marital trust known as a "QTIP Trust," and the executor could make a partial QTIP election for Tennessee purposes only, to the extent needed to avoid Tennessee inheritance tax. For many clients, the rigid requirements of a trust qualifying for QTIP treatment (e.g., all income must be paid to the spouse, and there can be no other beneficiary during the spouse's life) make this alternative unpalatable. Second, the formula clause could create two trusts at the first death, in lieu of only one Credit Shelter Trust. The first trust would be a typical flexible Credit Shelter Trust, funded only to the extent of the Tennessee exemption, not the full federal exemption. For example, in 2002, the Tennessee exemption is only $700,000. The second trust would be a QTIP Trust, funded with the balance of the federal exemption. For example, in 2002, the federal exemption would be $1 million so the QTIP Trust would be funded with $300,000. Then the executor would elect to apply the marital deduction to the QTIP Trust for Tennessee purposes, but not for federal purposes. Under the typical formula, the excess of the estate over the federal exemption would pass by marital deduction, either outright or in a separate marital trust, in order to avoid tax at the first death. As with the other funding alternatives, both the federal and Tennessee exemptions are fully used, but this approach also eliminates all taxes at the first death. You would choose zero-tax funding if you assumed the second spouse would die after repeal of the federal estate tax or after the exemption had exceeded the taxable estate, or if you wished to avoid all death taxes at the first death.

Rule #8. Add a "repeal" clause. Although existing wills may work well through 2009, they may create severe distortions in 2010 if Congress permits repeal to occur. Most formula clauses at the first death leave the maximum amount free of federal estate tax to the Credit Shelter Trust, which becomes the entire estate, and which could therefore completely exclude a spouse as beneficiary. Moreover, many typical Credit Shelter Trusts will not qualify for the "marital step-up" in basis described in Rule #3. Similarly, amounts left to charity at death often reflect a testator's balancing of various interests, including death taxes. With no federal estate taxes, a testator might choose to

give more to charity (e.g., the portion of the estate that would have gone to taxes before), or might reduce the amount to charity since there is no longer any subsidy from the taxman. Either way, it should be a conscious choice. A repeal clause would allocate the estate free of federal estate tax concerns. Also consider a "post-repeal clause." If Congress allows the sunset provisions of the new law to restore the federal estate tax to its pre-reform status in 2011, and if any changes to the estate plan have been made to take into account the increased exemptions, etc., then a sudden return to the current rules could distort the testator's plan in a different manner. Although 2010 may seem a long time away, any testator who becomes incompetent between now and then will have lost the opportunity to amend any further to take repeal, or post-repeal, into account.

Rule #7. Maximize flexibility. Since the tax laws are at best uncertain, and are highly likely to be modified again within a few years, build as much flexibility into estate planning documents as possible. Examples include:

(1) Leave everything outright to the surviving spouse, with language in the will that if, and to the extent that, the spouse disclaims, the assets will pass to a Credit Shelter Trust for the spouse's benefit for life. Thus the surviving spouse has nine months after the first death to decide what tax planning, if any, is desirable. The risks must be weighed against the benefits, since surviving spouses are notoriously reluctant to disclaim, even to a trust for their own benefit, no matter how compelling the tax argument. Also, a disclaimer trust cannot allow the surviving spouse to exercise discretionary powers as trustee or co-trustee, and cannot grant the spouse a limited power of appointment unless limited by an ascertainable standard.

(2) Leave everything to a QTIP Trust ("QTIP Trust #1"), even when the spouse's share would otherwise be outright. Provide that any portion over which the executor does not elect a federal marital deduction passes to another QTIP Trust ("QTIP Trust #2") for the benefit of the spouse for life.2 Provide further that any portion of QTIP Trust #2 over which the executor does not elect a Tennessee marital deduction passes instead to a Credit Shelter Trust, over which the spouse may be a trustee or have a limited power of appointment not limited by an ascertainable standard. The executor can file for an "automatic" six-month extension to file the decedent's federal and Tennessee death tax returns, giving a total of 15 months, if desired, in which to choose how to elect. If the clients want the marital share to be outright rather than in trust, give the surviving spouse the power to terminate QTIP Trust #1 to himself or herself at any time after 15 months from the decedent's death. This method differs from the disclaimer approach in paragraph (1) above by extending the time to 15 months in which to make a decision as to the extent of the credit shelter amount, by leaving the decision to the executor instead of the spouse, by permitting broader powers by the surviving spouse in the Credit Shelter Trust, and by allowing the executor to elect whether the Credit Shelter Trust should be zero-tax funded, fully funded, or super-funded for Tennessee inheritance tax purposes. Since there can be no "estate tax QTIP election" after repeal, this technique must include a separate "repeal clause" to allocate the estate appropriately after repeal.

(3) Give enormous discretion to the Trustee, so that, for example, a trust could be completely terminated if there were no longer any tax reason for its existence. Of course, such unlimited discretion can be dangerous, and must be granted only after weighing the risks as well as the benefits.

(4) Appoint a "trust protector" (usually an independent but trustworthy family

member) who is authorized to exercise a limited power of appointment to other family members, to amend the trust instrument itself, or even to terminate the trust.

(5) Add more extensive powers to the durable general power of attorney, including the power, after incompetence, to modify estate planning documents to the extent it would save taxes without disrupting the basic plan of disposition. Consider using a revocable living trust as a will substitute, since a power of attorney clearly cannot be used to amend a will. Or if there is no existing living trust, consider giving the agent the power to establish and fund a revocable living trust with dispositive terms identical to the principal's last will, with further power to amend that living trust as described above.

(6) Make sure beneficiary designations are coordinated with will planning. It is not uncommon to have a significant amount of wealth in IRAs or in various tax-favored plans (profit sharing, 401[k], 403[b], etc.). In addition to death tax exposure, these assets carry income tax liabilities. Beneficiary designations must be consistent with the overall plan. For example, naming "the estate" as beneficiary is usually not tax-efficient. Instead, consider a cascading sequence of potential beneficiaries, with each authorized to disclaim to the next, allowing maximum flexibility after death.

Rule #6. Make no taxable gift before its time. If the federal estate tax is ever repealed, everything will pass free of estate tax at death. Why pay for the privilege of transferring anything during life? In any event, the $10,000 annual exclusion remains viable, and the federal gift tax exemption is frozen at $1 million, so there is ample room for gifts up to those amounts before actually paying any federal gift tax out of pocket. The Tennessee gift tax remains a nuisance for any gifts in excess of the $10,000 annual exclusion ($3,000 for Class B beneficiaries).

Corollary to Rule #6: Use estate planning techniques that transfer wealth with little or no taxable gift. These might include: (1) loan to a child forgiven at death; (2) "zeroed-out" Grantor Retained Annuity Trust (GRAT); (3) "zeroed-out" Charitable Lead Annuity Trust (CLAT); (4) irrevocable trust for gift and estate tax purposes with provisions making it a "grantor trust" for income tax purposes, so that the grantor must pay the income taxes on the trust, in effect making a tax-free gift of the income tax liability paid by the grantor rather than by the trust (see also Rule #5 below); (5) sale to an irrevocable "grantor trust;" (6) "generation-skipping trust" to pass wealth from generation to generation with no gift or estate tax consequence; (7) accelerated gift to a Qualified Tuition Program (§529 Plan), with an election for federal gift tax purposes to have the amount of gift in excess of the annual exclusion taken ratably over a five-year period, eliminating estate tax on the excess if death occurs within five years and at the time of death repeal has occurred or the exemption has risen to exceed the taxable estate.

Exception #6-A. Make taxable gifts where otherwise desirable and the estate is likely to be subject to federal estate tax. Nothing under the new tax law diminishes the benefits of taxable gifts where there are valid reasons for making them (for example passing on a family business or removing limited partnership interests that are discounted in value), assuming that the estate is still likely to be subject to federal estate tax. Elderly clients may not survive until repeal, and many commentators believe Congress will never allow repeal to occur anyway. Taxable gifts in such case may often remove future income and appreciation from the estate, and may also remove any gift taxes paid from the tax base itself, thus reducing the effective tax rate. As under existing law, the transfer tax benefit of any significant gift must be weighed against the loss of step-up in basis for income tax purposes.

Exception #6-B. Make taxable gifts if the non-tax purposes override the detriment of incurring gift taxes. Tax planning is not the only, nor even the most important, reason for making gifts. Among the most significant reasons for making gifts are to provide funds for education (especially considering the income tax favored opportunities for doing so), to meet emergencies or unexpected expenses, to create trusts that protect against creditors, to provide funds for a career or business opportunity, and to help descendants enjoy benefits now that their resources would not otherwise allow.

Rule #5. Make irrevocable trusts "toggle switch grantor trusts" for income tax purposes. The Corollary to Rule #6 described the benefit through 2009 of a grantor trust for gift tax purposes. After 2009, ambiguity in a tax reform amendment to Internal Revenue Code §2511 makes the gift tax effect of a gift to a trust uncertain. Read literally, a transfer to a non-grantor trust will always be a taxable gift, with no $10,000 gift tax exclusion available, which implies that the $10,000 exclusion would be available only for a gift to a grantor trust. Read as we understand Congress intended, however, a transfer to a non-grantor trust will be a completed gift, as under current law, with all available exclusions, but a transfer to a grantor trust will not be a completed gift, and therefore not a taxable gift, until grantor trust treatment ends. Until this ambiguity is resolved, irrevocable trusts should be designed so that grantor trust status can be turned on or off.

Rule #4. Take advantage of the Generation-Skipping Tax (GST) exemption. It benefits future generations when trusts for their benefit have no exposure to gift or estate taxes. The incentive to create multiple-generation ("dynasty") trusts is no less, and perhaps greater, after tax reform. No matter what future Congresses may do, existing GST trusts are likely to be "grandfathered" against the application of new taxes. One problem between 2002 and 2009 is the significant inconsistency between the gift tax exemption, always $1 million, and the GST exemption, always greater than $1 million. Thus the GST exemption cannot be fully utilized during life without the imposition of some federal gift tax, which Rule #6 suggests avoiding. The techniques described in the Corollary to Rule #6 should work especially well with generation-skipping trusts.

Rule #3. Maximize "step-ups" in basis after estate tax repeal. If repeal ever occurs, capital gain tax is substituted for the estate tax, by imposing the decedent's "carryover basis" on heirs. Planning will shift to maximizing basis step-up. There will be a "standard" step-up for every estate of $1.3 million (adjusted annually for inflation after 2010), so that couples can generally step-up $2.6 million. (Note that the step-up means the total amount of basis increase, not the amount of assets on which basis is stepped-up.) In addition, there is a "marital" step-up of $3 million (adjusted annually for inflation after 2010) for assets left outright to a spouse or to an "income tax QTIP trust" under new Code §1022(c)(5). Thus, with proper planning, the total possible step-up for a married couple will be $5.6 million. After repeal, some wills may contain a formula clause to leave at least enough to the spouse (or an income tax QTIP trust) to obtain the full $3 million marital step-up, with the rest of the estate passing wherever else the testator desires.

Corollary #3-A. Keep good income tax basis records. To the extent that built-in gains exceed the allowed step-ups, the heirs take the decedent's carryover basis. Current Regulations detailing carryover basis for gifts provide that, where there is inadequate information, the basis will be presumed to be fair market value at the time of acquisition by the donor, if that can be determined.3 This could lead to endless paper searches if well-documented records are not available, or to painful negotiations with the IRS as to fair market value as of uncertain dates long ago.

Corollary #3-B. Weigh the potential for basis step-up in investment decisions. With carryover basis, some assets will be more advantageous to own at death and others less. For example, a life

insurance death benefit generally passes free of income tax at death, so a policy with a significant investment component receives the equivalent of a step-up in basis without using either the standard step-up or the marital step-up. Conversely, IRAs and other tax-deferred assets will not be eligible for any step-up at death.

Rule #2. Choose executors carefully. Beginning in 2010, the executor will have uncontrolled discretion in allocating the standard $1.3 million step-up in basis. If the executor is one of the beneficiaries, there may be no federal or state law to prevent him from allocating all of the step-up to his own inheritance rather than sharing the step-up with other estate beneficiaries. Consider adding rules in the will about allocating basis step-up.

And the number one rule for estate planning in Tennessee after tax reform:

Rule #1. Review estate plans, and amend if necessary, before Jan. 1, 2002.

Notes

1. Please feel free to contact the author at dholbrook@hpestatelaw.com for an Excel spreadsheet showing the combined federal and Tennessee death tax rates from 2001 forward.

2. These are often referred to as "Clayton QTIP's," after Estate of Clayton v. Comm'r, 976 F.2d 1486 (5th Cir. 1992), rev'g 97 T.C. 327 (1991). In that case and others, the court approved QTIP qualification when the non-elective portion passed to a non-marital trust with different terms. The IRS subsequently acquiesced and amended Regulation §20.2056(b)-7(d)(3) to approve this technique. If the surviving spouse is the executor, it is unclear whether a failure to elect QTIP marital deduction might be considered either a gift of the forgone income interest or the release of a general power of appointment. Until there is authoritative guidance, cautious drafting requires appointment of an independent executor, or, if the spouse is executor or co-executor, delegate the QTIP election power only to an independent co-executor or an independent "estate protector."

3. Regulations §1.1015-1(a)(3).

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