

2009: The Great Estate Distortion

Here's a problem for some of your estate planning clients: on Jan. 1, 2009, the federal estate tax exemption[1] rises to $3.5 million, up from $2 million in 2008.[2] Since current law would repeal the estate tax completely in 2010 but then return it in 2011 to pre-2001 levels, Congress and President Obama are highly likely during 2009 to freeze the exemption at $3.5 million for at least a few more years as well.

"The sheer number of clients who are now likely to eliminate federal estate tax planning means that more of them are likely to have to pay Tennessee inheritance tax than ever before. The Department of Revenue must be thrilled."

That's a problem? Well, yes, for some clients. Although taxpayers can generally only benefit from higher federal exemptions, there are several ways this huge increase may distort some existing estate plans.

1. Unnecessary Planning. Consider how many thousands, or even millions, of wills in this country have been written to create a trust at the death of the first spouse, in order to take advantage of that deceased spouse's federal estate tax exemption. After all, the rule on federal (and also Tennessee) exemptions is "use it or lose it," and many of our clients need both spouses' exemptions in order to shelter their estates.[3] Starting in 2009, if the couple's combined net worth is less than $3.5 million, such a trust could be not only unnecessary but even an intrusion into the life of the surviving spouse, creating loss of control and needless trustee hassle and expense.[4] In such cases, clients may be able to simplify everything and use "I love you" wills, leaving everything to each other, with remainder to the kids at the second death. No complicated tax planning, no undesired trusts at the first death.

2. Harm to the Surviving Spouse. Even when a couple's combined net worth is greater than $3.5 million[5] and tax planning would seem desirable, there is a hazard hidden in the standard formula language of most tax-planning wills. Typically such language provides that the estate of the first spouse to die leaves the exemption amount to a family trust and the rest of the estate to the surviving spouse, either outright or in trust, using the unlimited marital deduction. As the exemption has risen over the years, the proportion of the estate that passes into the family trust has risen concomitantly, at the expense of the share for the surviving spouse. Clients have understood this division of assets at the first death as necessary to accomplish a long-term objective of reducing or eliminating estate taxes for their children's benefit, so long as it didn't unduly interfere with the freedom of the surviving spouse. But clients may find that by allocating as much as $3.5 million to a trust at the first death, the surviving spouse will have far less of his or her own separate resources to live on than anticipated. Perhaps the trustee will be friendly to the surviving spouse, but perhaps not. Perhaps the other discretionary beneficiaries of the trust will be happy to let the surviving spouse have all the income, or to let the trustee dip heavily into the principal for the benefit of the surviving spouse, but perhaps not. Perhaps the trust document (or the Tennessee Uniform Trust Code with the consent of all "qualified beneficiaries") will allow the trust to be terminated and paid out in full to the surviving spouse if the trust no longer serves any tax purpose, but perhaps not.

This distortion is exacerbated if the exemption amount at the first death is bequeathed outright instead of in trust.

Some clients with adult children choose to give the exemption amount at the first death directly to the children, rather than in trust. For example, a client with an estate of $4 million might have planned for the $2 million exemption amount to pass outright to his daughter, leaving his remaining $2 million to his widow. When the exemption climbs to $3.5 million, the widow will get an estate residue of only $500,000, leaving the daughter with seven times more than what the spouse received, rather than an intended 50/50 split.

3. Harm to Charity. Some single, widowed or divorced clients have adapted the standard marital formula to give their estate residue to charity rather than to a spouse, relying on the charitable deduction instead of the marital deduction to eliminate federal estate tax. For example, a client with an estate of $3 million might have a will leaving her exemption amount to her children and the residue of her estate to charity, expecting the children to receive $2 million and charity $1 million. When the exemption rises to $3.5 million, the formula will leave nothing at all to charity, potentially thwarting a genuine charitable intent.

4. Paying More Tennessee Inheritance Tax. More estates than ever will pay Tennessee inheritance tax. The Tennessee inheritance tax exemption is only $1 million, with a top tax rate of 9.5 percent. In the past, whenever clients did federal estate tax planning, Tennessee inheritance tax planning was somewhat automatically included. This is because before 2000 the exemptions were the same, and since 2001 the excess of the federal exemption over the Tennessee exemption (the "Tennessee gap"[6]) has been relatively modest, so that the number of clients who were exposed to the Tennessee tax but not the federal tax were few enough. Beginning in 2009, the number of clients whose estates are in the "gap" will be significantly greater, making the question more important of whether it is desirable to create a trust at the first death merely to save Tennessee taxes. The maximum inheritance tax saving by creating such a trust at the first death is $95,000.[7] So for all clients whose estates are in the "gap," the answer might seem to be yes. But the choice of whether to create a trust for Tennessee tax planning when none is needed for federal planning depends upon how the clients choose to balance all their many other objectives besides saving taxes. For clients whose estates are closer to $1 million, the payment of inheritance tax is a significant portion of the estate, making the creation of a trust at the first death more attractive. For clients whose estates are closer to $3.5 million, potential death tax savings of "only" $95,000 may not be worth the cost, complexity, and loss of control. Ironically, therefore, for clients whose estates in 2009 and beyond are free of federal estate tax but remain subject to Tennessee inheritance tax, the larger the estate, perhaps the less likely the clients will plan for the state death tax alone. In any event, the sheer number of clients who are now likely to eliminate federal estate tax planning means that more of them are likely to have to pay Tennessee inheritance tax than ever before. The Department of Revenue must be thrilled.

As with any legal document, wills are merely tools to accomplish our clients' goals. Come 2009, many clients' estate plans may need to be simplified. Other plans may require adjustments to the formula clauses to avoid distortions to the clients' objectives. For example, it may be desirable to include some minimums or maximums in the formula clauses. This big change in the tax law presents new challenges for our clients and opportunities for us to help them better clarify and meet their objectives.

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Notes

1. Technically, this is not an "exemption" at all, but rather an "exemption equivalent," or more accurately still, an "applicable exclusion amount" under Internal Revenue Code section 2010(c). The shorthand term "exemption" is the most descriptive for the purpose of this column.

2. This 75% increase in the exemption is the largest single dollar increase ever and the highest percentage jump since it bounded from $60,000 to $120,667 in 1977. Over the last 30 years, we have seen incremental increases, partly to compensate for the effects of inflation, but to a greater measure to carry out Congress's intent to reduce the number of taxpayers subject to the tax. The number of federal estate tax returns filed declined from 108,071 in 2001 to 49,050 in 2006, approximately half of which are taxable estates in any given year.

3. Both presidential candidates endorsed "portability" of estate tax exemptions. This means that the exemption otherwise available to (and unused by) the estate of the first spouse to die will be transferred to the surviving spouse, thus "doubling" the exemption at the second death, and avoiding the need for any trust to be created at the first death. It remains to be seen whether Congress ever enacts such a provision, but if it does the arguments herein for avoiding distortion by eliminating trusts at the first death remain viable. In fact, even more clients will need the simplification, since any couple whose combined net worth runs as high as two times the exemption (up to $7 million if enacted in 2009) needs no federal estate tax planning.

4. Of course, there may be many non-tax reasons why a trust would still be helpful, such as a spendthrift spouse, a specific asset needing trust management, other beneficiaries of the trust, second marriage situations, and so forth. There can even be some income tax or gift tax benefits where there are multiple beneficiaries. The point is simply that for couples with a net worth under $3,500,000, the federal estate tax alone no longer provides any reason to create a trust under the will of the first spouse to die.

5. Married couples whose expected combined net worth exceeds twice the exemption will probably not need to change their wills. Their exposure to the federal estate tax is

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our household, and he occasionally rendered dissenting opinions, but not very often.

When I was in law school, a gal named Fran Ansley was at the top of my class. She graduated summa cum laude. I graduated laude have mercy.

Also while I was in law school, future-Justice Lee actually carried me to the championship round of the law school moot court competition. She was such an effective advocate that the judges focused totally on her and disregarded my weak arguments.

And, of course, I fell in love with Judge Claudia.

Now that my sons are grown and have flown the nest, I share a home with two strong women, one a judge (Claudia) and the other a princess, my daughter Margaret.

Princess Margaret talks about going to law school some day. If she does, she will be a third generation female lawyer. Her grandmother was one of two women in the University of Tennessee Law School Class of 1948.

I think it would be wonderful if the Princess eventually trades in her tiara for gavel. If so, someday, my granddaughter will say, "My grandmother and my mother were both judges."

And then, for good measure, she might add, "My grandfather was a lawyer, back in the days when most lawyers were men. Hard to believe, huh?" ⚖

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big enough not to be affected by nominal (to them) increases in the federal exemption. However, many such couples may find it difficult to ensure that each spouse has at least $3.5 million in his or her own name in case they are the first to die.

6. See Holbrook, "Top 10 Rules for Estate Planning in Tennessee after Tax Reform," 37 *Tenn. Bar J.* 12 (August 2001).

7. If husband predeceases wife, the amount of Tennessee inheritance taxes saved at wife's death by husband setting aside $1 million in a family trust at his death ranges from a low of $83,400 if the wife's separate estate is exactly $1 million to a maximum of $95,000 if the wife's separate estate exceeds $1,440,000. The difference is the use of lower tax brackets on the first $440,000. The inheritance tax saving will also vary to the extent the value of the trust assets change between the death of the first spouse and the death of the surviving spouse.