

PLANNING FOR UNCERTAINTY:
OR, HOW SAFE IS MY ESTATE PLAN
SINCE THE ELECTION IS OVER?

A Presentation Given By

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“We sail within a vast sphere, ever drifting in uncertainty, driven from end to end. When we think to attach ourselves to any point and to fasten to it, it wavers and leaves us; and, if we follow it, it eludes our grasp, slips past us, and vanishes forever. Nothing stays for us.”

– Blaise Pascal

I. AREAS OF UNCERTAINTY – TAX CHANGES.

A. PERMANENT REPEAL OF ESTATE TAX.

1. What Happened Four Years Ago.

a) Sunset Provision. As all estate planners could now recite in their sleep, the estate tax repeal included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) applies only to persons dying in the year 2010.¹ Unless Congress modifies the Internal Revenue Code in the meantime, on January 1, 2011, the estate tax will be re-instated, with all the exemptions and rules that would have applied in 2011 under the law as it read before EGTRRA.

b) Why a One Year Repeal? When EGTRRA was being considered by the Senate, supporters of repeal did not believe they could gather 60 votes in favor of repeal. Under the Congressional Budget Acts of 1974 and 1990, a vote of 60 Senators is required to pass legislation that would decrease tax revenues for a fiscal year more than 10 years after the present fiscal year. The 10 year window then available ended December 31, 2010.²

2. A New Bipartisan Era?

a) A Brief Hint of an Olive Branch. In the first couple of days after the 2004 general election, the Administration and the Republican Congressional leadership gave promising hints that they would try to make the next four years in Washington a time of more bipartisan cooperation.³

¹ EGTRRA §901.

² Zaritsky, *Waiting Out EGTRRA’s Sunset Period*, pp. 1-8 and 1-9 (2004).

³ “Vote Gives Bush Rare Opportunity,” by Jim VandeHei and Dana Milbank, *The Washington Post*, Nov. 4, 2004.

b) Heavy-Handed Approach Looking More Likely. It only took the passing of a few more days after the election to see evidence that the Administration and the Republican Congressional leadership regarded their success on November 2 as handing them a mandate to proceed with their agenda. These indications appeared in the following forms:

(1) Change in Senate rules sponsored by Senator Frist, allowing the Majority Leader to fill the first two vacancies on a committee, regardless of the seniority factor that used to control.⁴

(2) Change in House ethical rules, championed by Tom DeLay (R-TX.), the House Majority Leader, to allow a party leader to keep his post even if under indictment.⁵

(3) Last minute insertion into the omnibus budget bill that would have allowed Congressional committee chairs and staff access to any individual tax return, without regard to privacy protection.⁶

(4) Also in the omnibus budget bill, a provision denying federal funding to state agencies that discriminate against health care providers who disregard the state's requirement to provide abortion-related services, "a disgraceful sneak attack on women's health and freedom," according to one editorial.⁷

(5) The 2004 election saw a significant increase in the Senate of right-wing Republicans, which may diminish the influence of moderate Republicans (including Olympia Snowe (R-ME), Lincoln Chafee (R-RI), John McCain (R-AZ), Susan Collins (R-ME), and George Voinovich (R-OH)), as well as Democrats. Sen. Snow commented, "Regrettably, we have seen an erosion in the Senate of centrists on both sides of the aisle," while Marshall Wittman, a senior fellow at the Democratic Leadership Council said, "The locus of power has moved dramatically to the right in the Senate."⁸

⁴ "Senator Frist Tightens the Screws," Editorial, *The New York Times*, Nov. 27, 2004. "GOP Preps Stage for Bush Agenda," by Susan Milligan, *The Boston Globe*, Nov. 20, 2004.

⁵ Id. See also "A Moral Indictment," by Ronnie Earle, *The New York Times*, Nov. 23, 2004.

⁶ "Snookering the Taxpayers," Editorial, *The New York Times*, Nov. 24, 2004.

⁷ "Rolling Back Women's Rights," Editorial, *The New York Times*, Nov. 23, 2004.

⁸ "Rightward Shift May Squeeze Centrists," by Charles Babington and Juliet Eilperin, *The Washington Post*, Nov. 4, 2004.

(6) House Speaker Dennis Hastert recently announced a policy that he will allow legislation to come to the House floor for a vote only if it is supported by a majority of the House Republicans, regardless of the number of House Democrats who support it.⁹

3. Anticipating Senate Action.

a) **The 55/45 Split.** Republicans increased their majority in the Senate from 51 to 55 in this year's election. Since 60 votes are required to stop a filibuster, the Democrats, while holding an even smaller minority, can still hinder or even block Republican legislation, even assuming the Republican leadership controls 100% of their votes. But the significant change lies in the need for Republicans to persuade only five Democrats to join them – almost half the number they required previously. Democrats, on the other hand, will need to be more selective about those issues on which they are willing to raise the filibuster road block. This may open the way for Republicans to prevail with a simple majority vote on more issues than they could have in the last Congress.

b) Potential Aisle Jumpers

(1) **Some of the Most Vulnerable Democratic Senators.** The Democrats who would seem most likely to switch sides on tax issues are those who are from “red” states and who face re-election in 2006. There are five (exactly the number needed to stop a filibuster): Jeff Bingaman (NM), Robert Byrd (WV), Kent Conrad (ND), Bill Nelson (FL) and Ben Nelson (NE). Not only are the Nelsons from states where permanent estate tax repeal may be especially popular, they are both already targets of the Republican leadership for 2006.¹⁰ The effect of the defeat of Tom Daschle, the Senate Minority Leader, should not be underestimated. For many years, he was the Democratic example of a loyal party member in a Republican state. His defeat could have significant impact on the decisions of other Senators in similar positions.

(2) **Some Vulnerable Republicans.** On the other side of the aisle, there are three moderate Republicans from “blue” states who are also up for re-election in 2006: Lincoln

⁹ “Hastert Launches a Partisan Policy,” by Charles Babington, *The Washington Post*, Nov. 27, 2004.

¹⁰ “For Democrats in Red States, 2006 Daunting,” by Amy Fagan, *The Washington Times*, Nov. 29, 2004.

Chaffee (RI), Rick Santorum (PA) and Olympia Snowe (ME).

c) Are There 60 Votes for Repeal?

(1) The Vulnerable Democrats. Of the five Democrats listed above, Senator Byrd is the least likely to switch sides on a tax vote. He has a strong record of supporting Democratic Party positions. Moreover, it is uncertain whether he will even run again for office – he will be 89 when his current term expires at the end of 2006. When the Senate last voted on making the estate tax repeal permanent on June 12, 2002, both Nelsons crossed party lines and voted with the Republicans. It seems highly likely that they would do so again. The other two vulnerable Democrats, Bingaman and Conrad, are seen as long shots for switching to vote for repeal, in part because each of them last won re-election with more than 60% of the vote in their respective states.¹¹

(2) Other Democrats. Five other Democratic Senators who are returning to this Congress voted for repeal the last time the Senate considered the issue. They are Mary Landrieu (LA), Max Baucus (MT), Blanche Lincoln (AR), Evan Bayh (IN) and Ron Wyden (OR). Other Democratic Senators who have expressed support for estate tax repeal, although they did not vote for it in 2002, include Dianne Feinstein (CA), Patty Murray (WA) and Tim Johnson (SD).¹² It should be noted that the 2002 bill was never expected to gain the required number of votes to pass. The fact that a Senator votes for a bill, knowing that it will not pass, is not a good indicator of whether that Senator will take the same position on a vote that “really counts.”

(3) Republican Changeovers. Of the three Republican Senators listed above as vulnerable, only Lincoln Chafee has a record that would suggest he might break ranks with the party. The other Republican who may be likely to vote against repeal is John McCain.

(4) So Where Do We Stand? The count seems to come down to this: 55 Republican Senators, minus Chafee and

¹¹ “News Analysis: 60-Vote Majority at Hand for Estate Tax Repeal,” by Martin A. Sullivan, Tax Notes Economic Correspondent, Tax Analysts, Inc., Nov. 29, 2004 web article for Planned Giving Design Center, www.pgdc.com.

¹² Id.

McCain, leaves 53 Republicans in favor of repeal. They are likely to gain the Nelsons, taking them back up to 55. The issue will be whether then can find five more Democratic votes from among the eight Senators listed above who have previously voted for or endorsed repeal. Baucus and Bayh are both from agricultural states that voted for Bush by about 60%. They could probably be persuaded fairly easily to vote again for permanent repeal. (Remember the burden of estate taxation is allegedly destroying the family farm.) Whether the supporters of repeal can recruit three more Democratic Senators will probably depend upon exactly how and when the proposal is put to a vote and the other uncertainties described below. ***While still uncertain, the prospects for repeal are greater than ever and planners should look at permanent repeal as a very real, if not highly likely, possibility.***

d) Potential for Repeal Is Greatest Before April 2006. Republican leaders realize that the President has a relatively brief opportunity to leverage his popularity and the results of the 2004 election. By April 2006, all House members and one-third of the Senate will be concerned about the 2006 midterm elections and the ensuing presidential election in 2008.¹³

B. EXTENSION OF OTHER EXISTING TAX CUTS AND OTHER PENDING TAX CHANGES.

C.

1. Administration Plans. Administration officials have signaled that they will begin a push in early 2005 to make permanent the remaining Bush tax cuts that are still scheduled to sunset, including the estate tax repeal. This probably will occur separately from, and before, the Administration presents its over-all tax reform package discussed below.

2. Incentives for Charitable Giving. As part of the Administration's faith-based initiative, two tax provisions to encourage charitable giving have languished in various pieces of legislation that never made it out of Congress during President Bush's first term. These provisions, which were included in the "CARE Act" as well as other bills, would (a) allow an income tax charitable deduction for individual taxpayers who do not itemize and (b) allow taxpayers to roll over IRAs and other retirement benefits tax free to charities. Senator Reid, the new Minority Leader in the Senate, has indicated that Democrats are not opposed to either of these

¹³ "Vote Gives Bush Rare Opportunity," by Jim VandeHei and Dana Milbank, *The Washington Post*, Nov. 4, 2004.

changes.¹⁴ We should expect them to be re-introduced and enacted early in the next Congress. Charitable organizations generally have seen these as two very valuable tax changes that could significantly enhance charitable giving.

D. OTHER TAX REFORM PROPOSALS.

1. Process Announced. The President has announced that he will appoint a bipartisan advisory panel before the end of 2004 to make recommendations on tax reform to the Treasury Secretary in a relatively short time. If the panel makes its recommendations in the first half of 2005, the Administration could have implementing legislation proposed and debated by the end of 2005. This could result in new laws effective as early as 2006.¹⁵

2. Elimination of Tax on Investment Income and Capital Gains.

a) Building Upon First Term Changes. Administration officials have implied many times that a likely component of a comprehensive tax reform act would, in effect, eliminate federal income tax on investment income and capital gains. These overhauls would build on the legislation adopted in 2003 that significantly reduced the tax rates on qualifying dividends and capital gains. These provisions, which are set to expire in 2009, would be made permanent and expanded to include all dividends as well as large, tax exempt savings accounts that could be drawn upon by the taxpayer at any time and for any reason.¹⁶ This would leave the income tax, essentially, as a tax on earned income.

b) Revenue Offset. The Administration has suggested that the cost of making investments tax-free should be paid by eliminating the itemized deduction for state and local taxes, and by eliminating the corporate deduction for employee health insurance. (One cannot help noting that eliminating the deduction for state taxes would hurt most the residents of states with high income taxes, like New York and California, which were “true blue” in the 2004 election. Nor can one avoid the irony of increasing the cost to employers of providing health insurance at the time when already soaring premiums are already requiring many employers to cut back or eliminate these benefits.)

¹⁴ “GOP Sees Chance to Pass Faith Initiatives,” by Amy Fagan, *The Washington Times*, Nov. 26, 2004.

¹⁵ “G.O.P. Constituencies Split on Tax Changes,” by Edmund L. Andrews and David D. Kirkpatrick, *The New York Times*, Nov. 22, 2004.

¹⁶ *Id.*

c) Changes Would Have Enormous Impact on Estate and Financial Planning.

(1) The tax status of various investments would become irrelevant. The tax-free status long enjoyed by the inside build-up in values of life insurance, as well as the municipal bond market, would no longer impact investment decisions. This change, combined with permanent estate tax repeal, could have a major negative impact on the life insurance industry. It would also increase significantly the borrowing costs encountered by state and local governments, which are already in perilous financial circumstances.

(2) Another surprising effect of these changes involves carry-over basis. EGTRRA intended to offset the cost of estate tax repeal with a new carryover basis regime.¹⁷ If, however, the capital gains tax is eliminated, basis also becomes irrelevant, whether stepped-up or carryover. Further, whatever appeal life insurance might have presented as a hedge against eventual capital gains tax on inherited property is also thus lost.

(3) Finally, these changes would eliminate the policy justification for retaining the gift tax. When EGTRRA was being drafted, the Senate amended the House version of the Act to retain the gift tax permanently and keep its exemption at \$1 million. The primary purpose was to preserve the integrity of the capital gains tax by preventing family members from freely transferring assets to those in lower tax brackets.¹⁸ If there is no capital gains tax, however, this concern disappears. Presumably, Congress could then come full circle and repeal the gift tax.

d) Polls Suggest Public Ambivalence About Tax Reform Agenda. In a New York Times/CBS News Poll from late November, “nearly two-thirds of all respondents -- including 51% of Republicans -- said it was more important to reduce deficits than to cut taxes, a central element of Mr. Bush’s economic agenda.”¹⁹

3. Replacement of Income Tax with National Sales Tax or Something Similar. One major, fundamental tax reform that will likely be considered

¹⁷ EGTRRA §§ 541, 542, amending IRC §§ 1014, 1022.

¹⁸ Zaritsky, *Waiting Out EGTRRA’s Sunset Period*, p. 1-5.

¹⁹ “Americans Show Clear Concerns About Bush Agenda,” by Adam Nagourney and Janet Elder, *The New York Times*, Nov. 23, 2004.

as an alternative over the next two years is the complete replacement of the income tax with some form of consumption tax, such as a national retail sales tax or a value-added tax. House Speaker Dennis Hastert has endorsed a national sales tax. Representative John Linder (R-GA) has 54 co-sponsors for a bill that would replace all individual and corporate income taxes with a national sales tax.²⁰ In-depth discussion of such a proposal is well beyond the scope of this presentation.²¹

“My thoughts are whirled like a potter’s wheel. I know not where I am or what I do.”
– Talbot, in Shakespeare’s *Henry VI*, act 1. sc. 5, 1, 19.

II. OTHER AREAS OF UNCERTAINTY

A. INVESTMENT CLIMATE.

1. Recent Positive Economic Indicators.²²

- a) 3rd quarter real GDP of +3.9% exceeded the original estimate of +3.7%.
- b) Unemployment dropped from 5.5% in October to 5.4% in November.
- c) Personal income increased by +0.6%, more than expected.
- d) Personal spending in October increased by +0.7%, more than expected.
- e) Factory orders increased by +0.5%.
- f) ISM manufacturing index reached 57.8, indicating economic expansion.

2. Recent Negative Economic Indicators.²³

- a) Only 112,000 jobs were added to the economy November and numbers for September and October were adjusted downward.

²⁰ “G.O.P. Constituencies Split on Tax Changes,” by Edmund L. Andrews and David D. Kirkpatrick, *The New York Times*, Nov. 22, 2004.

²¹ For more information see, e.g., Gale and Orszag, “Tax Policy in the Bush Administration: Down Payment on Tax Reform?” *Tax Notes* 105(7): 879-884, Nov. 8, 2004.

²² *Bob LeClair’s Finance and Markets Email Newsletter*, December 4, 2004, Archive Message # 264, from Leimberg Information Services, www.lisi.com.

²³ Id.

(New jobs should be between 150,000 and 200,000 to keep up with labor supply.)

b) Manufacturing sector lost 5,000 jobs; retail sector lost 16,000 jobs, even with the beginning of the holiday sales season.

c) Consumer confidence fell for the fourth straight month, to 90.5.

d) Construction spending stayed the same, rather than increasing as expected.

e) Personal income has increased, but savings continues to be at a national rate of 0.2%.

3. General Outlook for 2005. Most advisors seem to be cautiously optimistic about the stock market, projecting single digit total returns for a well balanced and diversified portfolio. Bond markets are starting to feel the effect of likely inflationary pressures and increasing interest rates. Oil prices are expected to remain high. Every projection is subject to radical change if there is a major problem with the oil supply or a major international or terrorist incident.

B. INTERNATIONAL AFFAIRS. One only needs to look at any daily newspaper or news broadcast to see how full of peril the world is. A large proportion of Americans voting for President Bush cited as a major reason for doing so their belief that he could better protect the nation and carry on the war on terrorism. There is a pervasive anxiety about unpredictable violent attack that, to this writer, seems unparalleled since the Cold War days of fallout shelters and air raid drills in the 1950's and 1960's.

C. EFFECTS ON CLIENT ATTITUDES.

1. Mortality Awareness. As the global situation has become more unstable, the war in Iraq has dragged on with no end in sight, terror alert levels have gone up and down, and terrorist activity in other parts of the world has increased, most clients (especially those living in large metropolitan areas) have become quite aware of their own mortality. They understand readily the need to plan their affairs and to complete those plans in a timely way. But even these concerns have not eliminated the very human tendency to delay dealing with unpleasant issues, especially death.

2. Gift Planning. Clients have greater concerns for their own financial and personal security and are less certain of the reliability of their own investments. Generally, this makes clients less willing to part with significant assets permanently.

3. Investment Performance. Many clients are still concerned about obtaining investment yields that will meet their current spending needs or keep pace with inflation. Freezing estate values or simply shifting future increases in value may be less important simply because many clients question whether those increases in value will materialize any time in the foreseeable future. The return of the DJIA to well over 10,000 has reduced this concern to some extent. Few, if any, clients still assume, however, that their estates will grow from year to year.

4. Tax Planning in General. Most clients are keenly aware of the uncertainty of the tax laws. While they may not appreciate all that is pending or being considered, they do recognize that any tax planning may have a short shelf-life. They tend to be most receptive to planning suggestions that will be viable over several years, regardless of what happens in Washington.

“To quarrel with the uncertainty that besets us in intellectual affairs would be about as reasonable as to object to live one’s life with due thought for the morrow because no man can be sure he will be alive an hour hence.”

– Thomas Henry Huxley

III. KEYS TO ESTATE PLANNING IN THIS ENVIRONMENT.

A. RETAIN FLEXIBILITY. With so much uncertainty facing clients and their advisors, the most prudent step a planner can take is to build into each estate plan as much flexibility as possible. This will allow the client and the family to deal more effectively with whatever new circumstances may arise in the law, the economy or the family situation. Some of the best ways to preserve flexibility, even in irrevocable documents, include:

1. Discretionary Trusts. Giving the trustee of a trust broad discretion to make distributions to beneficiaries can be a very important tool in keeping the plan flexible. It can allow the trustee to tailor distributions of assets to take into account tax law developments, economic changes and changes in the circumstances of family members.

2. Powers of Appointment. This old legal tool can be an excellent way to allow family members to modify a plan, even after it becomes irrevocable. To the extent consistent with existing tax planning requirements and with the client’s wishes, it may be highly desirable to have someone with a power of appointment exercisable any time the plan cannot be changed by the client. Powers of appointment, however, force the client to rely on the power holder to take the actions the client would

have wanted and work only if the power holder has the capacity to exercise the power at the required time.

3. Disclaimers. Another way to build flexibility into a plan is to design it with possible disclaimers in mind. If the client would want different dispositions of property depending upon the circumstances that actually occur, the plan could be structured to provide one result, with provisions that would create the different result if a key beneficiary disclaims the first disposition. The planner must pay careful attention to the requirements for qualified disclaimers under IRC §2518, particularly the prohibition on the disclaiming beneficiary receiving future benefits from the property (unless the disclaimant is the surviving spouse). Disclaimers, of course, rely on the cooperation of the beneficiary holding the power to disclaim and on that beneficiary's capacity to make the disclaimer at the necessary time.

4. Alternative Specific Provisions. In some cases, it will be obvious to the client and the planner that a specific disposition should or should not occur, depending upon certain facts. If the planner can articulate the circumstances clearly enough, the planner could use alternative provisions, each of which would become operative only upon the occurrence of the specified circumstances. This approach does not leave the execution of the client's wishes depending upon the cooperation and good health of a particular beneficiary.

5. Trust Protectors. Increasing numbers of planners are considering the use of "trust protectors" or persons with a similar function to safeguard the estate plan from unpredictable developments. This office, which became a well known as a feature of international asset protection trusts, could be used in other circumstances. The client could give the trust protector the power to make changes in the estate plan when the client cannot. The trust protector normally would not be a primary beneficiary, but an advisor, close family friend or other family member who would be sympathetic to making changes to carry out the client's wishes in spite of changes in law or circumstances. In many ways, it is similar to the power of appointment approach discussed above.

B. LEVERAGE EXEMPTIONS. As long as there is an estate tax or gift tax in place, planners should advise clients to use exemptions carefully. Leveraging exemptions means using techniques that will allow the effective transfer of more value than must be reported for gift or estate tax purposes. All of the discounted value techniques could be considered in this area, particularly where the client wants to transfer assets during life to family members for non-tax reasons. Current law gives each client a fixed gift tax exemption of \$1 million, which is not scheduled to increase and which will remain in place as long as the gift tax itself does. Wealthy clients could quickly find themselves limited in the amount

they can transfer to family members during life, even if they are not concerned with an estate tax at death.

C. AVOID PAYMENT OF GIFT TAX.

1. Prior View. The received teaching of estate planners has long been that the making of lifetime transfers may be an excellent tax savings device, even if it requires payment of a gift tax. Because the gift tax was calculated on a tax exclusive basis, it could be a less costly way to transfer assets than passing them through the estate, where a tax inclusive calculation was involved.

2. Current Concerns. If, however, the client's estate would not be subject to estate tax, either because of permanent repeal or because of increasing estate tax exemptions pending repeal, the old reasoning does not prevail. Why should the family pay gift tax early on assets that could eventually pass tax free? Absent some compelling need to make the transfer during life, it makes no economic sense to pay a gift tax in such cases.

D. FREEZE ESTATES.

1. Comfort to Concerned Clients. Estate freeze techniques can be very useful in the current climate of uncertainty. Under most freeze plans, the client retains some benefit from or access to the assets themselves. This can be reassuring to clients who are concerned about their own financial freedom and security.

2. Potential Tax Savings. In addition, the estate freeze prevents the client's own estate from continuing to grow by shifting future growth to other family members at little or no tax cost. They can keep the client's estate tax problem from getting worse.

IV. TIMELY TECHNIQUES²⁴

A. MARITAL DEDUCTION PLANNING.

1. Review How Repeal Would Impact Your Formula Provisions. Most marital deduction formula provisions now in use seek to reduce the estate tax on the death of the first spouse to zero. This goal can be achieved by various types of formula provisions. They will operate

²⁴ It is assumed that the reader has or can easily obtain basic information about the various techniques described in this portion of the outline. The discussion of these techniques will not attempt to explain them or provide guidance on how they should be implemented; rather, it will seek only to identify their particular strengths and weaknesses as ways of planning for uncertainty.

differently if the estate tax is repealed or does not apply to the estate because of the increased exemptions. A couple of examples follow.

a) “Largest Amount That Can Be Given Without Increasing Estate Tax.” This language would normally describe the gift to the marital deduction trust. If the estate tax is repealed, or does not apply because the total estate is within the amount of the exemption, this formula gives the whole estate to the marital deduction gift. This may give all the economic benefits of the estate to the surviving spouse, a particular problem in second marriage situations. It also could subject the spouse to QTIP restrictions that are not needed if the estate tax no longer applies.

b) “Smallest Amount Required to Reduce Estate Tax to Zero.” This language would normally describe a gift to the by-pass or credit shelter trust. If there is no estate tax, either because of repeal or because of high exemptions, this language would result in nothing passing to the by-pass or credit shelter trust. The amount required to reduce a non-existent tax to zero is zero. Since many clients use the by-pass or credit shelter trust to provide benefits directly to descendants upon the death of the first spouse, this formula could block the accomplishment of the client’s goals.

c) “Maximum Amount Qualifying for the Marital Deduction.” Obviously, this would describe the gift to the marital deduction trust or to the spouse. The effect of this clause after a repeal of the estate tax is not completely clear. Since there would be no marital deduction available, the maximum amount qualifying for it would seem to be zero. The provision might be construed, however, to refer to the maximum amount that could have qualified under the law in effect when the document was signed. In that case, it could cover the whole estate.

2. Remember to Check the Effects of State Tax Decoupling Provisions. Another concern involving the marital deduction formula relates to the different approaches the various states have taken in “decoupling” their state estate tax from the federal estate tax. Nearly half the states have enacted legislation of this kind in response to the elimination of the state death credit under EGTRRA. In many cases, the states are using smaller estate tax exemptions than apply in the federal law. The drafter must carefully analyze the language to determine whether the formula gives to the by-pass or credit shelter trust the full amount available under federal law or the smaller amount that is exempt under state law. Under current federal and Illinois law, this does not become an issue until 2009, when the federal exemption will increase to \$3.5 million but the Illinois exemption will remain at \$2 million. It is not

too early, however, to review existing marital deduction formula provisions in light of this change.

B. SECTION 529 EDUCATION SAVINGS PLANS.

1. Brief Description. One of the great benefits of EGTRRA to a broad class of taxpayers was the improvement of §529 qualified tuition plans (“QTPs”). Generally, a donor makes a contribution to a QTP sponsored by a state or by a private college or university. The funds are allowed to accumulate income tax free. If the funds are used to pay for qualified higher education expenses, there is no income tax on the distribution. The owner of a QTP can change the beneficiaries of the plan and even take back the funds. Donations to the QTP, however, qualify for the gift tax annual exclusion and assets in the QTP are not includible in the estate of the donor.

2. Uses in Planning for Uncertainty. This is one of the most useful techniques ever developed. It allows the donor to set aside funds for the higher education of any person, while allowing the donor the option to change the beneficiary or take the money back. If the donor does not do so, the income of the QTP is tax exempt (if used for higher education expenses), there is no gift tax on the contribution and the assets of the QTP are outside the estate of the donor. It allows the donor complete flexibility in dealing with almost all of the areas of uncertainty we have discussed. This is a “no brainer” for almost every client.

C. EXCLUSION GIFTS – ANNUAL, MEDICAL AND TUITION.

1. Brief Description. Gifts of present interests can be made each year, up to \$11,000 per beneficiary, without using any gift or estate tax exemption or paying any gift tax. In addition, a client can pay medical or tuition expenses directly to the provider or educational institution, in any amount, with the same tax benefits as for the annual exclusion.

2. Uses in Planning for Uncertainty. Many clients are comfortable making these gifts and feeling that their own financial security is preserved. They involve relatively smaller amounts than many other techniques and the client can reconsider each year whether to make such gifts. They do not lock the client into a large irrevocable gift or program. Yet they do provide gift and estate tax savings that can add up to significant amounts depending upon the number of donees.

D. GRATS.

1. Brief Description. The zero-out GRAT, as approved in the *Walton* case,²⁵ is a fairly risk-free estate freeze technique. The client can make a tax-free gift of most of the income and appreciation from the assets transferred to the GRAT, without giving away the underlying assets themselves. The client also keeps a portion of the total yield of the assets roughly equal to the §7520 rate for the month in which the GRAT is created.

2. Uses in Planning for Uncertainty. The zero-out GRAT can transfer an asset's yield, in excess of the §7520 rate, tax-free to other family members. It is an excellent way to leverage the client's gift tax exemption, since there is no taxable gift involved. The client has not parted with the value of the underlying assets, because they are distributed back to the client over the term of the GRAT. If the assets fail to yield more than the §7520 rate, the client is in no worse position than if the client had done nothing, other than the transaction costs of setting up the GRAT. The assets themselves are back in the client's estate, where they can receive a basis step-up under current law.²⁶

3. Restoring Assets to Grantor if Estate Tax is Repealed. Many clients will be interested in the zero-out GRAT to remove assets from the taxable estate, rather than accomplish lifetime transfers to family members. Such clients may want to regain control of the assets in the GRAT if the estate tax is permanently repealed. There are at least three ways to accomplish this.

a) Contingent Reversion Requiring Repayment to Client if Estate Tax is Repealed. Using this technique will not cause the gift to the GRAT to be incomplete (since it is contingent on an event outside the client's control),²⁷ nor will it affect the amount of the gift since the reversion is not a qualifying interest under §2702. It will cause the trust to be a grantor trust for income tax purposes under §673 (as well as §677), and it will cause inclusion of the GRAT in the client's estate if death occurs before the end of the GRAT term. But these results apply to a GRAT anyway, so the contingent reversion is not making the situation any worse.

b) Discretionary Power of Independent Trustee to Return Assets to Client if Estate Tax is Repealed. Use of this technique

²⁵ *Walton v. Commr.*, 115 T.C. 589 (2000), *acq.* Notice 2003-72, 2003 44 IRB 964.

²⁶ For more information, see Harrison, "Avoiding Gift and Estate Taxes With Grantor Retained Annuity Trusts," 29 *Est. Plan.* 528 (Oct. 2002).

²⁷ Treas. Reg. §25.2511-2(b).

also should not prevent the gift to the GRAT from being complete,²⁸ or alter the value of the gift under §2702.

c) Power of Appointment to Return Assets to Client if Estate Tax is Repealed. The same tax results should apply using this technique as well.

E. SALE TO IDGT.

1. Brief Description. This is an estate freeze technique, in which the client creates an irrevocable trust that is a grantor trust for income tax purposes but is not includible in the client's estate when the client dies. If the client sells appreciated assets to the trust, there is no recognition of gain on the sale because the trust is a grantor trust. The value in the client's estate is frozen at the face amount of the note, plus interest at the applicable federal rate. The yield on the assets sold, to the extent it exceeds the interest owed to the client, will pass tax-free to the beneficiaries of the trust.

2. Uses in Planning for Uncertainty. This technique allows the client to shift the future yield of the assets above the AFR tax-free to family members. It does not require the use of any gift or estate tax exemption, except for the "seed money" that may be needed in creating the trust. The client retains ownership of the original value of the asset in the form of the note. One downside of this approach is that the value of the note stays the same and generally will be included in the client's estate at face amount, even if the assets sold decline in value. This tool is similar to the GRAT, but there are significant differences in the details between the two.²⁹

F. SELF-CANCELLING INSTALMENT NOTE ("SCIN").

1. Brief Description. Client sells assets to family members or trusts in exchange for a promissory note that has a self-cancellation feature. (In other words, if the client dies before the debt is fully repaid, nothing further is owed under the note.) The borrower pays a premium for this feature in the form of increased principal or a higher rate of interest.³⁰

2. Uses in Planning for Uncertainty. This technique allows the client to remove assets from the client's taxable estate immediately. It does not merely shift future appreciation, as does the GRAT or the sale to the IDGT. One of the risks is that the client will actually live long enough to

²⁸ Id.

²⁹ For an extended discussion of sales to IDGTs, see Zaritsky and Aucutt, *Structuring Estate Freezes*, ¶12.02[5] (2d ed. 1997).

³⁰ See Held and Newlin, "Hedging Death and Taxes: Self-canceling installment note transactions can minimize the short-term economic risk of mortality," *Trusts & Estates* pp. 56 – 60 (January 2004).

receive all of the payments provided under the SCIN. In that case, the client's estate has actually been increased in size because of the premium paid for the self-cancellation feature.

G. INTRA-FAMILY LOANS.

1. Brief Description. Client lends money to other family members, charging only the minimum rate of interest required under §7872. Family members invest the funds in ways to produce a rate of return higher than the §7872 rate. This additional yield passes to these other family members free of any gift or estate tax.

2. Uses in Planning for Uncertainty. This technique also allows tax-free shifting of income and appreciation to other family members. At the same time, the client retains the original assets in the form of the promissory note and can access those assets according to the terms of the note. It is also a simple way to make funds available to needy family members without incurring a gift tax or using gift tax exemption. The current low rates of interest required make this a useful tool. Since most planners expect interest rates to increase at some point over the next several years, it could be advisable to lock in the current low interest rates for a long term loan.

H. IRREVOCABLE LIFE INSURANCE TRUSTS.

1. Brief Description. The irrevocable life insurance trust continues to be an excellent tool for removing insurance death benefits from a client's estate at minimal gift tax cost.

2. Uses in Planning for Uncertainty. Irrevocable life insurance trusts are used solely as estate tax savings devices. (There may be other reasons to hold the policy and proceeds in trust, but it is the estate tax benefit that requires the use of an irrevocable trust.) If the estate tax is permanently repealed, it may no longer be necessary to keep the life insurance at all, or at least not in the limits of the irrevocable trust. The trust should authorize the trustee to change investments, including surrendering and replacing policies. There should also be an effective "escape hatch" in the form of a power of appointment or trust protector's power to modify the trust, so that the scheme can be unwound if its estate tax protection becomes unnecessary.

I. CHARITABLE LEAD ANNUITY TRUSTS.

1. Brief Description. These are irrevocable trusts that pay a fixed amount to charity for a specified period, at the end of which the remaining trust property passes to the client's family or other beneficiaries. Such

trusts are used primarily to save gift and estate taxes. These taxes apply to the present value of the remainder interest, and not to the whole amount given to the trust. This can result in a substantial discount of the amount subject to gift or estate tax.

2. Uses in Planning for Uncertainty. Testamentary lead trusts will lose their appeal if the estate tax is repealed. (Charitably minded clients could still provide benefits to charity without the complications involved in the lead trust qualifications.) Inter vivos lead trusts, however, will be a very useful way to leverage the gift tax exemption and transfer additional funds tax free to family members during the client's life.

V. CONCLUSION.

A. TAX LEGISLATION. There is a high probability that:

1. the repeal of the estate tax will be made permanent;
2. the other tax cuts already enacted by the Bush Administration will also be made permanent;
3. the "Care Act" provisions for charity will be enacted; and
4. the Administration will push hard for elimination of the income tax on investment income and capital gains, if not the replacement of the income tax with some sort of consumption tax.

B. INVESTMENT CLIMATE AND INTERNATIONAL AFFAIRS. Investment advisors are cautiously optimistic about steady single-digit yields in the stock market and about general economic recovery. This is all fragile and especially susceptible to problems with the oil supply or international affairs.

C. CLIENT ATTITUDES. Clients will probably remain cautiously optimistic in handling personal financial and estate planning.

D. ADVISOR APPROACH. The good financial or estate planning advisor will recognize these concerns, and will develop plans based on retaining flexibility, leveraging tax exemptions, avoiding payment of current gift tax and freezing estate values.