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Navigating Estate Plans Through Uncharted Waters



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Uncertainty caused by the temporary federal estate tax repeal

The failure of Congress to preserve the federal estate and generation-skipping transfer (GSTT) taxes has created a challenging estate planning environment. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) brought about the repeal of these transfer taxes for 2010, but the federal gift tax remains intact with a \$1 million lifetime exemption and a top tax rate of 35 percent. Further, a modified carryover basis system replaces the long-standing step-up in basis rule promoting the income taxation of appreciated assets when these assets are sold by the estate's heirs. And, these changes are only temporary--in 2011, the estate and GST taxes are scheduled to return to their 2001 status (i.e., \$1 million exemption and top rate of 55 percent). On top of that, Congress could reinstate these taxes (retroactive to January 1 or otherwise) or enact an entirely new transfer tax regime, adding to the uncertainty currently surrounding estate planning. How should an estate planning professional proceed under these circumstances?

Estate tax planning vs. capital gains tax planning

As of January 1, 2010, federal estate and GST taxes are repealed, meaning that estates, in general, may transfer assets of any value without being subject to these taxes (although state death taxes may still be imposed, see below for further discussion). While dying in 2010 could mean the avoidance of transfer taxes, there is instead the potential imposition of federal capital gains tax on the sale of appreciated assets when they are sold by estate beneficiaries. Thus, for individuals who are very old, very ill, or terminally ill, immediate attention may be needed to steer an estate plan away from minimizing estate taxes and towards minimizing capital gains taxes.

Prior to 2010, in general, the basis of estate property was its fair market value on the date of the decedent's death. In 2010, the basis of estate property is the lesser of the asset's fair market value on the date of death or the decedent's (carryover) basis. For example, assume the decedent's basis in property is \$2 million with a date-of-death fair market value of \$4 million. Beneficiaries inheriting the property will receive it with the lower \$2 million carryover basis. If the property is subsequently sold for \$4 million, the beneficiary may realize a capital gain on the difference between the selling price (\$4 million) and the carryover basis (\$2 million).

However, two special basis adjustments may apply. The first adjustment allows estates to exempt up to \$1.3 million of appreciation or gain on property that is passed to any beneficiary. The second adjustment allows estates to exempt up to \$3 million of property that passes to a surviving spouse, or as "qualified terminable interest property" (QTIP). These exemptions are separate, so an exemption of \$4.3 million can be applied towards property going to a surviving spouse (with nothing left over for property passing to other beneficiaries).

Example(s): Assume an unmarried decedent's estate consists of a farm worth \$1.5 million with a basis of \$500,000 (\$1 million gain), and stock worth \$1 million with a basis of \$500,000 (\$500,000 gain). The estate administrator may exempt up to \$1.3 million of the total gain (\$1.5 million). The exemption can be allocated to assets at the discretion of the executor, unless the decedent specifically directs otherwise in the will or trust. Thus, the entire \$1 million gain from the farm can be exempted with the remaining exemption (\$300,000) applied to the stock (leaving \$200,000 of taxable gain). Or the entire gain from the stock can be exempted, with the exemption balance applied to the farm (leaving a capital gain of \$200,000).

Tip: Determining a decedent's basis can be very important. Special attention must be paid to determining and documenting how and when assets are acquired or received, the acquisition cost, and any additional increases in basis.

Caution: There are other rules that may also affect the basis of property. For example, the decedent's basis in property can be increased by unused capital loss carryovers, net operating loss carryovers, and by Internal Revenue Code (IRC) Section 165 claims for theft losses and worthless

securities, among other things. You may need to consult with a tax professional to understand all these issues.

How these exemptions are allocated among various estate assets will take careful consideration. Some questions to consider include:

- What type of asset is it?
- What is the basis of the property?
- Do other adjustments need to be applied to the asset's basis?
- Who is the intended beneficiary of the asset, and what is his or her tax bracket?
- What is the intended use of the inherited asset, (i.e., is it expected to be sold or held)?
- If the asset is a principal residence, is the federal income tax home sale exclusion (\$250,000) available to reduce the gain from the sale?

Review plans for formula clauses

Many wills and trusts were drafted in contemplation of transfer taxes, so they contain provisions that allocate or direct the distribution of assets based on formulas or other directions in order to minimize these taxes. In particular, wills and trusts created for married couples frequently employ a formula to minimize potential federal estate tax by utilizing the federal estate tax exclusion amount of the first spouse to die. This is usually accomplished by dividing the estate of the deceased spouse into a marital trust for the benefit of the surviving spouse and a family trust (also referred to as a credit shelter trust or bypass trust) for the benefit of children. The family trust is funded up to the decedent's unused estate tax exclusion amount and the marital trust receives the balance of the estate. But if there is no estate tax in the year of death, how is such a provision to be interpreted? For example, if the document references funding of the family trust with an amount equal to the maximum that will pass free of estate tax (i.e., up to the applicable exclusion amount), if there is no estate tax, could this language be construed to mean that the entire estate passes to the family trust? If the surviving spouse is the beneficiary of both trusts, there may be no problem, but if the spouse has no right or access to assets in the family trust, then the surviving spouse could theoretically be left with nothing.

Similarly, for donors who are charitably inclined, estate planning documents may leave a percentage of the estate or a dollar amount to a charity out of that portion of the estate exceeding the applicable estate tax exclusion amount. Again, if there is no estate tax, it's conceivable that no gift will be made to the charity.

In light of these and other potential issues, it is best to review estate planning documents and make necessary revisions to accomplish the intent of the owner. Wills and trusts should be drafted to clearly reference what should happen if the owner dies when there is no estate tax, or if the exclusion amount is greater or less than the 2009 amount (\$3.5 million). Thus, documents will need to provide flexibility in their distribution provisions to accommodate the possibility of many varied scenarios.

Gifting opportunities and issues caused by the repeal of the GST tax

The temporary repeal of the GSTT provides an opportunity to make gifts to skip beneficiaries free from the GSTT. In 2010, large gifts to grandchildren, subject to both the gift tax and the GSTT in prior years, now are subject only to the gift tax (at a 35 percent tax rate).

Creating and funding a dynasty trust for skip beneficiaries (i.e., grandchildren and younger generations) also may be a viable planning option that takes advantage of the temporary GSTT repeal. In addition, if the trust proceeds are used to provide for the beneficiary's education or health care, even if the GSTT is reintroduced, those distributions are not subject to the tax.

For those who have begun gifting through the use of dynasty or similar trusts, 2010 may be the time to

accelerate trust distributions or terminate the trust altogether. The trust may allow the trustee discretion to make distributions to or for any of the trust beneficiaries. In general, the GSTT applies to taxable distributions to skip persons, and on taxable terminations resulting in a shift from one generation to the next. If the trust corpus exceeds the applicable GSTT exclusion amount (\$3.5 million in 2009, \$1 million in 2011), trust distributions or terminations may be subject to the GSTT. In 2010, unless the law changes, there is no GSTT to infringe on these transactions.

However, if the GSTT is imposed retroactively, gifts thought to have escaped the GSTT may be captured by it after all. This possibility must be weighed against the potential tax savings of gifting without the GSTT to determine the best course of action.

Testamentary gifts to skip beneficiaries may be based on the applicable GSTT exemption (gifts to skip beneficiaries up to the applicable GSTT exclusion amount, the remainder to children or other beneficiaries). For deaths in 2010, the repeal of the GSTT could result in the entire gift being made to skip beneficiaries with nothing to remainder beneficiaries. Documents may need to be amended to include a different formula to account for the possibility that there is no GSTT exemption when allocating gifts to grandchildren.

Addressing the impact of state death taxes

Prior to 2001, many states tied their death tax (sometimes called a credit estate tax, sponge tax, or pickup tax) to the federal state death tax credit. The passage of EGTRRA eventually replaced the state death tax credit with a deduction. Thus, states that coupled their death tax to the federal credit saw its elimination. Some states responded by simply linking their death tax to the federal credit that was in effect prior to 2001 (\$675,000) or some other amount. Other states decoupled from the federal system altogether and enacted a separate inheritance or estate tax. And, those states that did nothing anticipate the potential reinstatement of their death tax in 2011 when the federal credit is scheduled to return. Planning for both federal and state transfer taxes (some states also have a gift tax and/or GSTT) has become extremely difficult and complex. Creative planning will be required.

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