ST. LOUIS BUSINESS JOURNAL

IN DEPTH: ESTATE PLANNING
From the December 6, 2002 print edition
Roundtable discussion

The state of estate planning

The changing nature of the federal estate tax has increased the challenges involved in estate planning.

Around the table

Jonathan Igoe, partner, Armstrong Teasdale

Igoe is chairman of the trusts and estates practice group at Armstrong Teasdale and is assistant chairman of the health care practice group. He is also co-chairman of the firm's employee benefits, pension and executive compensation department. Igoe has focused his practice primarily on estate planning and employee benefits. He is a member of the Estate Planning Council of St. Louis.

Larry Katzenstein, partner, Thompson Coburn

Katzenstein practices in Thompson Coburn's private client services area with a concentration on estate planning and charitable giving. He has been retained by the Internal Revenue Service to provide continuing legal education programs to IRS estate and gift tax attorneys. He appears annually on several American Bar Association-American Law Institute estate planning programs, and has spoken at many other national tax institutes, including the Notre Dame Tax Institute and the Southern Federal Tax Institute. Katzenstein is an adjunct professor at the Washington University School of Law where he has taught both estate and gift taxation and fiduciary income taxation.

Carolyn Ohlsen, associate, Bryan Cave

Ohlsen joined Bryan Cave in 1997, after six years as an associate with a St. Louis general practice firm. Her practice involves all phases of estate, trust and partnership planning, and she focuses on the representation of family businesses, particularly in regard to succession planning. She also handles estate planning for qualified plans and Individual Retirement Accounts. Ohlsen has been an instructor of courses in estates, trusts and real property law and lectures frequently on estate planning and tax-related topics. She is a member of the Estate Planning Council of St. Louis.

Gary True, partner, Burroughs, Hepler, Broom, MacDonald, Hebrank & True

True practices principally in the areas of estate planning, corporate and business law, mergers and acquisitions, and taxation at Burroughs, Hepler, Broom, MacDonald, Hebrank & True. He is a Certified Public Accountant and was a partner with a major St. Louis public accounting firm prior to becoming an attorney. True is a member of the Estate Planning Council of St. Louis.

SLBJ: Under last year's gradual repeal of the federal estate tax, the status of the tax will vary year to year over the next 10 years. How can individuals safeguard against the uncertainty of the estate tax? How should this influence their planning?

Jonathan Igoe: First, the law providing for ultimate repeal will very likely be changed. Although total repeal occurs in 2010, the law enacting the tax cut will expire the very next year. This means that, in 2011 and beyond, estates will be taxed as if the tax cut was never enacted. A law under which total repeal lasts only one year (2010) is untenable. Therefore, one should keep close watch on federal legislative developments, as Congress will have to address this issue at some point. What Congress will do is uncertain. Consequently, flexibility should be built into estate planning documents where possible.

Second, an individual needs to review periodically his or her net worth, family situation and estate planning documents to determine how much is likely to pass to the individual's beneficiaries. A formula for allocating assets based on the estate tax exemption may need to be altered to avoid an unintended disinheritance of a beneficiary. For instance, if the amount equal to the estate tax exemption is to be distributed to descendants with the balance to the spouse, the spouse will gradually receive less and less as the exemption increases. Thus, if a person dies in 2006 with an estate of $2 million and the amount of the exemption (which will then also be $2 million) is to pass to the children with the balance to the spouse, the spouse will in fact receive nothing.

Third, a couple should consider the need to re-allocate their assets between themselves so that each continues to make maximum use of the estate tax exemption. This may require transferring assets from one spouse to the other.

Fourth, at least until 2010 the estate tax will still exist. Between now and then, the estate tax exemption will increase, while the top rate of taxation will decrease. As a consequence, we generally recommend to a husband and wife that they structure their estate plan to avoid estate tax at the death of the first spouse. In the past, it sometimes made sense for the estate of each spouse to pay some tax. This would be true when the combined tax payable by both estates was projected to be less than the estate tax paid by the survivor's estate. Under the 2001 tax act, a couple's estate plan should generally be structured to avoid paying taxes at the death of the first spouse because the survivor's estate may have to pay nothing or very little in the way of estate tax depending upon the year of the survivor's death.

Finally, where there is concern that a person may not have the ability to change his or her estate plan as future circumstances may dictate, consideration should be given to granting another the power to do so.

Larry Katzenstein: Any planning tied specifically to exemption amounts or rates should utilize formulas which self-adjust. For example, if the intent is to shelter as much as possible from estate tax in a credit shelter trust, use of a formula is indispensable because the amount exempt from tax will rise every year. In some cases, the absolute number of dollars passing under certain provisions may require adjustment. For example, a client may wish for the amount exempt from tax to pass to specific family members if the exemption is $1 million. But the same client may also feel that when the exemption rises to $3.5 million, that is more in absolute dollars than the client would like to leave to a family member. Or the client may feel that a trust should be utilized for this larger sum rather than an outright bequest.

Carolyn Ohlsen: Estate planning becomes even more complicated after last year's repeal. Even after 2010, there will continue to be uncertainty about whether repeal will be retained.

I think the key is flexibility. For example, insurance trusts will continue to be attractive techniques, but they should be structured to make sure the beneficiaries have access to the policy during the insured's lifetime. Planned disclaimers are also attractive because they give the surviving spouse the control to achieve optimum tax results no matter what year death occurs.

Gary True: The best way to safeguard against the uncertainty of the estate tax is to plan under the current tax law, but build flexibility into the plan to allow for changes that are inevitable in the current political climate. A simple example is a "trust protector" provision in an irrevocable trust that allows an independent third party to terminate the trust under certain conditions, including his or her decision that the trust will no longer serve its intended purpose because of the repeal of the estate tax or other changed circumstances.

We can be relatively certain (but not positive) of the estate tax rates and other rules for individuals dying before Jan. 1, 2004. A good plan will take into account the current provisions without causing the individual to take actions that will be unduly costly or have other undesirable results, if the action is likely to be unnecessary if the individual (or spouse, if married) lives until increases in the lifetime exclusion or repeal take effect.

There are risks, of course, involved in betting that the estate tax will be repealed or the exclusions increased. Each situation must be examined to determine the best way to build flexibility into the estate plan while providing protection against changes in the tax laws.

SLBJ: How did last year's Tax Act affect provisions for gift taxes?

Igoe: While the exemption for gift and estate taxes through the year 2003 has been raised to $1 million, the exemption for gift taxes will not increase any further. This is true even though the estate tax exemption will continue to increase over time or even if the estate tax itself is repealed. Therefore, techniques estate planners have typically employed in the past when a donor makes a gift, to reduce or eliminate the amount of gift tax paid, remain important tools.

In the past, it sometimes made economic sense to make a gift which resulted in the payment of a gift tax. Now, with the estate tax exemption being greater than the gift tax exemption after 2003 and with the possible repeal of the estate tax, it may not be advisable to make gifts that cause the donor to pay a gift tax, as his or her estate may not have to pay an estate tax later. This makes it more important than ever to use various giving techniques that reduce or eliminate the amount of any taxable gift.

Katzenstein: Although the amount exempt from estate tax rises each year until full phase-in of the law in 2009 and scheduled repeal in 2010, the amount exempt from gift tax is capped at $1 million because of perceived income tax abuses possible under a higher exemption. However, the top gift tax rate will fall over the next few years, paralleling the fall in the top estate tax rate to 45 percent. Interestingly, the gift tax would be retained even after full estate tax repeal because of the same perceived income tax abuses, with a top rate of 35 percent.

Ohlsen: By maintaining the gift tax in this fashion, Congress is actually protecting income tax revenue that might otherwise be lost if high-income taxpayers were able to transfer assets to lower-income taxpayers if no gift taxes were imposed.

Given the possibility of permanent repeal, making taxable gifts is less appealing to clients, meaning that wealthy clients will have to find more leveraged ways to use their gift exemption, to transfer growth out of their estates, without making a large current gift — using estate freezing or discount giving techniques (or perhaps some combination).

True: The annual gift tax exclusion ($11,000 per donee) is also not affected by the law changes. Other than potential increases in the annual exclusion amount as it is indexed for inflation (which will likely have little effect, in light of the current low inflation rate), the gift tax provisions will not change unless amended by a future tax act.

SLBJ: What are the other provisions of the new tax law that individuals should be educated about when forming their estate plans?

Igoe: The rules regarding the taxation of generation skipping transfers ("GST") have been made more favorable. A generation skipping transfer is generally a transfer of property which skips a child or is not taxed in the child's estate and which passes to a grandchild or lower generation descendant. The GST tax is a punitive tax designed to discourage a person from skipping his or her children in favor of lower generations. There is, however, an exemption available. Beginning in 2004 the amount of the GST exemption will be the same as the estate tax exemption. In addition, the GST tax is to be repealed in 2010 along with the estate tax. Furthermore, the rules governing how the GST exemption may be applied have been liberalized in the taxpayer's favor.

The rules governing Section 529 plans, already quite favorable to taxpayers, have been further revised to the taxpayer's favor. Distributions from a Section 529 account for certain eligible expenses are no longer subject to income tax and the definition of those expenses has been broadened.

Katzenstein: Some of the more radical provisions of the new tax law become effective only if the estate tax is in fact fully phased out in the year 2010. For example, at that point, except for a limited adjustment, assets passing at death will not receive a new cost basis as they do under present law. This will present significant compliance problems. Once the new tax law is fully phased in, the estate tax after the exempt amount will be essentially a flat tax. That will change many of the planning techniques we have used in the past, such as making certain that we utilize the bottom tax brackets of the first spouse to die by paying some tax at the first death.

Ohlsen: In addition to repeal, the new tax law enacts a carry-over basis. Going forward, finding ways to avoid tax under the new carry-over basis system will be important. This will involve strategies that shift assets into investments that are not included in gross income for tax purposes, such as life insurance. The states that do not impose a state income tax will also look even more attractive, especially if they do not impose a state death tax.

Although not a part of the new tax law, we obviously will be monitoring new legislation introduced in the new session of congress; given the sweep by the Republicans, there will be a push to make the repeal of the death tax permanent, if that can be done in the budget process; as an alternative, we may see a push for much higher exemptions, faster than the current law phases them in.

True: Repeal of Stepped-Up Basis. The repeal of the estate tax includes a repeal of the step-up in income tax basis of assets owned at death. The income tax basis of each asset received from a decedent after repeal will be the lower of its fair market value or its adjusted cost basis in the hands of the decedent. An exception allows a basis step-up for $1.3 million of assets, plus an additional $3 million of assets passing to a surviving spouse (the executor picks which assets receive the basis increase).

Although this does not take effect until 2010, individuals should begin keeping accurate cost basis information for all of their assets to avoid leaving their beneficiaries the task of reconstructing it, which can be an accounting nightmare.

Reduction in Estate Tax Rates. The top estate tax and gift tax rate is reduced from 55 percent (2001 and prior) to 50 percent in 2002, then gradually down to 45 percent by 2009. The gift tax rate is 35 percent after the elimination of the estate tax in 2010. Although not major, these changes will affect the calculations necessary to properly plan.

SLBJ: When a thriving family business is part of an estate, how can families best pass the business on to the next generation without taking too big of a hit from taxes?

Igoe: This is a very difficult issue and is highly dependent upon on the family's situation, financial and otherwise. There is no one-size-fits-all solution. Furthermore, what to do over the coming years will be greatly affected by whether the estate tax is repealed or, if it is not, how high the estate tax exemption is set. Careful, long-term planning is required and tax savings should by no means be the sole driving force. Non-tax factors include the willingness of the founder or current management to part eventually with the business and whether there are descendants ready and able to operate the business. Also important is how likely it is that members of the next generation will get along with each other, particularly if some are active in the business and others are not. Sometimes, it is better to give the business to a particular child of the owner and have other assets pass to the other children. If, however, the business is the major asset, this approach may not be feasible.

Generally, a sustained giving program using many of the more sophisticated techniques for making gifts can be quite helpful. Re-capitalizing (for instance, the issuance of non-voting stock) and sale to the owner's children of at least some interest in the business, perhaps on an installment basis, may also be appropriate. Finally, consideration should be given to whether life insurance may be of use.

Katzenstein: With assets such as a family business, one of the most common ways of providing liquidity for taxes is through life insurance on the primary share holder, typically held by an irrevocable insurance trust so it will not be taxed in the deceased shareholder's estate. In addition to the limited relief provided by the tax law, such as the ability to pay the estate tax over 10 years in some cases, much can be done to reduce the value of the family business for tax purposes. For example, minority interests can be transferred during lifetime and these will be discounted for valuation purposes. Ideally, when the family member dies his or her interest in the family business will itself have been reduced to a minority interest through these gifts, and that remaining interest will be valued at a discount. Other discounts, for example reflecting non-marketability, can be taken as well. During lifetime, particularly when interest rates are low as they are now, future growth in a family business can often be transferred tax-free to family members through grantor retained annuity trusts and other similar devices.

Ohlsen: Our business succession plans for family business clients are usually structured to help the senior generation pass ownership of the business along to the younger generation. Under estate tax repeal, there will be no death tax, but there will still be a tax cost to making gifts. Therefore, the senior generation will be motivated to hold on until death. As a result, the natural succession of ownership through the generations will be delayed, and many family businesses may actually be hurt by the repeal act.

Again, wealthy families with successful businesses will have to consider ways of moving growth in the business to active family members without current gift tax, using freeze techniques, such as installment sales, grantor retained annuity trusts, gifting interests which are entitled to valuation discounts, or other sophisticated planning techniques.

True: This is the crux of the planning for most of my estate planning clients. Estate tax planning must be done hand-in-hand with other aspects of business succession planning. In addition to estate taxes, family and marital issues, management succession, asset protection planning and other concerns are key elements of a good estate and succession plan.

The time at which the current owner is willing to pass ownership to the next generation must be considered. Most estate tax planning techniques for a family-business owner involve him or her giving or selling, during his or her lifetime, ownership to the family member(s) who will receive the business after he or she dies. If the senior generation is willing to transfer ownership (even if not voting rights) sooner rather than later, there are several options to reduce estate taxes.

Gifts of stock (or other forms of ownership, such as LLC Interests): Before transferring ownership, even if only one share of stock to a child, a buy-sell agreement should be implemented to prevent stock from going to ex-spouses or creditors of beneficiaries, or anyone else the donor does not want to be an owner of the family business. Also, one or more trusts, or non-voting stock, may be utilized to avoid giving voting power to, or delaying the receipt of voting rights by, those beneficiaries who might not be desirable shareholders. Gifts of stock in the family business can reduce the owners' estate taxes in three ways.

First, gifts of stock (or other form of ownership) up to the amount of the gift tax annual exclusion remove value from the donor's estate.

Second, gifts equal to the lifetime exclusion ($1 million per person; $2 million if married) remove the future appreciation in the value of the stock from the donor's estate without the payment of gift tax.

Third, it is usually possible to "discount" the value of the stock given to family members because the shares represent a minority interest and are not marketable, which is usually the case for stock of a privately-held company.

Planning for discounts at death: If the current owner (senior generation) gives or sells enough stock so that he or she owns a minority interest at death, the stock remaining in his or her estate may be entitled to a discount for lack of control and lack of marketability.

Planning for the family-owned business deduction: The family-owned business deduction is a reduction in the taxable estate, not to exceed $300,000, if the estate includes stock in a family-owned business and certain ownership and other requirements are met. The deduction is effectively an increase of the estate tax exemption to $1.3 million from $1 million for qualifying estates. Although the 2001 Tax Act repeals this provision after 2003, some minor adjustments in the ownership of a family business can preserve the $300,000 deduction in the estate of a business owner who dies this year or next, while allowing a minority interest discount for the stock owned at death.

SLBJ: What are the other new/upcoming issues in estate planning that individuals in the St. Louis metro region need to be informed about?

Igoe: As far as other estate planning issues, a big one is how to deal with qualified plans/IRAs. These kinds of assets are subject not only to estate tax but also to income tax. Taxes can greatly diminish a beneficiary's inheritance when plan

proceeds are the taxpayer's major asset. Unfortunately, the estate tax and income tax rules work at cross purposes. What may be best from an estate tax perspective may cause an increase in income taxes and vice-versa.

Katzenstein: The current low interest rates are the major recent development in estate planning. Many estate planning techniques are dependent on federal interest rates which change monthly. When interest rates are low, techniques such as grantor-retained annuity trusts, sales of family businesses or other appreciating assets to family trusts, intra-family loans, private annuities and similar techniques are particularly desirable. This may be a once in a lifetime opportunity to use these techniques at these historic low interest rates. Grantor-retained annuity trusts (or GRATs) are particularly desirable now because of low interest rates and because of the uncertainty as to whether there will be an estate tax when our clients die. GRATs can be structured to pass wealth to family members with little or no gift or estate tax. Because clients don't know if the estate tax will in fact be repealed, many are reluctant to make gifts that generate gift tax even though gift tax continues to be cheaper than estate tax. GRATs are a way to make transfers to family members without generating current gift tax.

Ohlsen: Many people don't realize that there is a new tax law concerning IRAs and other retirement plans, that might be just as important as estate tax repeal for many taxpayers. This new law is the Final Regulations on minimum distributions, that was published on April 17, 2002.

In planning for large IRA account balances, the main goal is to keep the assets inside the IRA as long as possible, to shield the built-up assets from income taxation. The Final Regulations make it easier to do this, by publishing new tables to help taxpayers calculate their required minimum distributions. Taxpayers will have an easier time calculating required minimum distributions using the new tables. The tables also incorporate updated life expectancy data that will actually allow taxpayers to take their distributions over a longer period of time. Beginning in 2003, calculating required minimum distributions will be even easier, because the new tax law requires IRA issuers to provide information to taxpayers to assist them in calculating the amount of the distribution, or even to calculate it for them.

True: Split-Dollar Life Insurance Changes. Many business owners use so-called "split dollar" life insurance plans in connection with life insurance to provide liquidity for their estates or to fund a buy-sell agreement. Under a typical split-dollar plan created between a business and its owner/employee for estate tax purposes, one party (the company) pays the insurance premiums and the other party (an irrevocable trust created by the owner) may designate the beneficiary of the life insurance policy. The company is entitled to repayment of the premiums upon the death of the insured or the termination of the policy. The insured's trust receives the balance of the death benefit. A split-dollar plan is essentially an interest-free loan from the company to the insured.

The value of the insurance protection is taxed to (or paid to the company by) the insured annually. The annual value is essentially the cost of one-year term insurance for that year (taking into account the insured's age). The one-year term cost is considered a gift from the insured to his trust. The use of split-dollar plans has allowed business owners to purchase more insurance without exceeding the annual gift tax exclusion because only the one-year term cost, and not the entire premium, is considered a gift.

There are many other uses and variations of split-dollar plans and there are several other tax issues to consider. However, all split-dollar plans are affected by recent IRS regulations. Existing plans must conform to the new rules by Jan. 1, 2004.