

OVERLOOKED TRAPS AND OPPORTUNITIES IN ESTATE PLANNING

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The federal estate tax is essentially a **confiscation tax** by which the federal government has the right to confiscate assets upon wealth transfers. It is, however, largely a **voluntary** confiscation tax because pre-death planning can assure substantial reduction of this confiscation. This article will discuss a few often overlooked planning opportunities and tax traps for the unwary.

Unlimited Marital Deduction When the Congress enacted the unlimited marital deduction in 1992, it provided that the new marital deduction rules would not apply to wills executed before September 12, 1981, unless a state statute specifically provided for the application of the new rules. Many states have not adopted such statutes (e.g., Georgia). Therefore, wills executed before September 12, 1981 which contain an allocation of "the maximum marital deduction" may be limited to a marital deduction of the greater of \$250,000 or ½ of the estate - resulting in the incursion of estate taxes and the passage of assets in a manner that the decedent may not have wanted.

For example, assume a married client with a \$3.0 million estate has a pre-1982 will which provides that the "maximum marital deduction" goes outright to a spouse and the balance goes to a Bypass Trust. There are children from a prior marriage who are the remaindermen of the Bypass Trust. Unless the children agreed to a disclaimer, at the client's death, \$1.0 million would pass to the spouse and the balance to the Bypass Trust, resulting in a \$578,000 estate tax liability which could have been deferred to the spouse's death.

Powers of Attorney As Americans live longer, incapacity is becoming a growing issue. Guardianship is an expensive and time consuming process which can often be replaced by a well drafted power of attorney. To add flexibility and protect the family there are a number of provisions, which should be placed in a power of attorney designed to provide for incapacity, including:

- Gifts. The IRS takes the position that an annual exclusion gift cannot be made unless the power of attorney or state law specifically provides for such gifts. Such authority almost always makes sense, and the power could be restricted to provide that the gifts do not reduce the estate below the applicable unified credit (i.e., the tax benefit of annual exclusion gift ceases if there is no taxable estate). The grantor may also want to place other conditions on gift giving.
- Estate Planning. Particularly for clients who are facing imminent incapacity, allow the power holder, with written approval of designated parties, to make estate planning decisions for the maker such as transferring assets to a living trust.

- Tax Powers. To authorize dealing with the IRS, the power of attorney must make specific reference to the particular years (e.g., "1985 through 2020") and tax forms to which the power applies (e.g., "1040, 709, 2848").
- Durability. A "durable" power of attorney is one, which survives incapacity. Although some state statutes (e.g., Georgia) deem a power of attorney as automatically durable, not all states do so, and if a power of attorney is necessary in such a state (e.g., to transfer real estate to a living trust to avoid ancillary probate), the power of attorney may not be enforceable unless it specifically provides that it survives the maker's subsequent incapacity.
- Guardianship. In many states the appointment of a guardian automatically revokes the power of attorney. To avoid backdoor contests, specially appoint the power holder as the guardian.
- Safety Deposit Box. Give the power holder authority to open any safe deposit box, even if the power holder is not listed on the signature card. Authorize the power holder to drill the box if the keys are lost.
- Real Estate. Allow the power holder to "acknowledge" a signature. This is required by some states to convey real estate.
- Health Care. While the person may have a medical power of attorney allowing someone to make medical decisions for them, the general power of attorney should also allow the power holder to make payments incurred by the health care power holder.
- Domicile. The power of attorney may authorize the power holder to change the state of residence of the maker (e.g., Florida to reduce income taxes).

Contemplation of Divorce Divorce is a persistent problem in our culture. Whenever an irrevocable trust is established during a married grantor's life, make sure it contemplates the possibility of divorce. To protect the grantor, the document might provide that the divorce or legal separation:

- Automatically terminates any rights the spouse has under the trust instrument;
- Results in the automatic termination of the spouse's appointment as a trustee of the trust;
- Results in the automatic termination of any right the spouse has to remove and/or replace a trustee; and

Allows the trustee to hold the income of the trust or expend income or principal as the trustee deems appropriate, without having to pay to the guardian (e.g., the ex-spouse) of any minor children.

Gifts in Other States. Often an advisor will advise his or her client that their wealthy relatives should look at making lifetime annual exclusion or unified credit covered gifts. Beware that state taxes may result. For example, gifts in Tennessee, which would be covered by the Unified Credit, may still result in the imposition of a Tennessee gift tax. Gifts in Pennsylvania, which might be covered by the \$10,000 annual exclusion, may be subject to a Pennsylvania inheritance tax if the donor dies within a year of the gift.

Annual Exclusion Gifting. A married client has a large piece of real estate which has been placed in a family partnership and which he intends to transfer by annual exclusion to twenty (20) family members. The donor has expressed concern that one family group with only four (4) potential donees would be detrimentally impacted because the other two family groups have eight (8) donees. The donor wants all family groups to be benefited in a comparable basis and therefore, is discussing limiting the annual exclusion to \$40,000.00 per family group (the maximum annual exclusion of the smallest family). There are at least two better alternatives:

First, instead of reducing the annual exclusion gifts to \$240,000 maximize the family exclusion at \$400,000.00 using gift splitting. Make up the amount for the smaller families; using some of the donors' unified credit, either during life or by will. Although this reduces the available unified credit at death it still increases the overall tax-free dispositions to the family. In effect, the use of the unified credit for the smaller families benefits the entire family group.

Second, create a lifetime trust, with all descendants as beneficiaries. The spouse may be a CO-Trustee. Contribute at least \$200,000 to the trust using the annual exclusion. The trust is divided into three equal trust shares for each family, even though the Crummy withdrawal right among the family groups differs. A "spray power" could allow the CO-Trustees to make income or principal distributions to family members when needed. At the death of each of the children, all of that trust share is distributed to their children. The growth in the contributed assets will not be subject to estate taxes. Assets could be invested in low income investments which generate growth and capital gains. See *Est. of Kohlsaas v. Comm'r.* and *Holland Est. v. Comm'r.*

Deathbed Checks Deathbed annual exclusion gifts are a significant planning tool. In Revenue Ruling 96-56, the IRS ruled that if the donor dies before the check clears his or her account, the gift is not removed from the estate. In *Estate of Newman*, 111 T.C. No. 3 (July 28, 1998), the Tax Court agreed with the IRS's position. Therefore, if deathbed gifts are made with the intent of applying the annual exclusion, do certified checks or wired funds so they are immediately drawn from the account.

Drafting Crummy Powers. The IRC section 2503(b) \$10,000 annual exclusion applies only to "present" interest - i.e., the donee must have the present use and enjoyment of the property. By nature, a gift to a trust is a future interest. A "Crummy Right" is a provision placed in a trust to convert the contribution from a "future" interest to a "present interest" by giving beneficiaries the right to withdraw trust contributions for a limited period of time. Among the planning issues related to Crummy powers are:

- If the annual exclusion changes as a result of inflation adjustment, specific dollar withdrawal rights can create problems. Instead reference: "the annual exclusion amount permitted by IRC section 2503(b)."
- To avoid having a beneficiary be treated as an additional grantor to the trust under the 5&5 provisions of IRC section 2514(e), the withdrawal right should be the greater of \$5,000 or 5 percent of the trust principal. Using a straight \$10,000 withdrawal right will violate the 5&5 power when the trust holds less than \$200,000. In such case, the beneficiary whose right has lapsed is deemed another grantor of the trust - creating all sorts of potential tax problems.
- To provide greater flexibility, allow a contributor to the trust to deny any beneficiary's right to make a withdrawal, and/or to modify the amount subject to withdrawal.
- In order to simplify the process, provide that any beneficiary who is also a trustee has the first right of withdrawal and is deemed automatically to have notice of withdrawal rights upon any contribution. This will eliminate the need to provide actual notice to beneficiaries if the withdrawal rights of Trustee/Beneficiaries exceed the annual contributions to the trust.
- Provide in the document that a minor's withdrawal right can be exercised by a parent or legal guardian.
- To avoid the argument that the withdrawal right is contingent upon the powers of others involved with the trust, provide that it is superior to all other trustee powers and authority.

- If a spouse is to be a beneficiary of the trust, consider providing that his or her rights as a beneficiary and/or trustee are automatically terminated upon divorce or legal separation.

Allocating the GST Exemption. The application of the GST exemption is either determined on a timely filed gift tax return or the value of the property at the time of the allocation. This can result in terrible inadvertent consequences. For example, assume a party places \$1,000,000 in a trust, with income to the grantor's child for a number of years. If the child is alive at the end of the period, he takes the remaining assets in the trust. If he is dead the assets pass automatically to the grandchild of the donor. The assets are worth \$5 million when the child dies and are passed to the grandchild. If the GST exemption is not elected on a timely filed gift tax return, a GST tax of \$2,200,000 (55% times \$4 million) could be imposed. Failure to allocate the GST exemption to Crummy withdrawal rights can have similar problems.

Executor's Fees. Most states provide for a statutory executor's fee that ranges from 2% to 5% of the value of the assets in the probate estate. One method of reducing the overall taxes on a large estate is to pay a larger executor's fee. If the estate is in a 55%-60% tax bracket, a tax savings almost always will result for beneficiaries who serve as executors. For example, assume an estate at \$15,000,000 provided for a 3% executor's fee. This would result in a \$450,000 estate tax deduction and if the beneficiary/executor were in the top individual income tax bracket of 39.6% a total savings of \$100,800.

If a living trust is used to avoid probate, the executor's fees can never be paid, resulting in the inadvertent payment of additional estate taxes which far exceed the benefit of avoiding probate. Moreover, executor's fees paid to someone who is not in the trade or business of being an executor are not subject to self employment taxes (i.e., social security taxes). See Revenue Ruling 58-5 1958-1 CB 322. In many states both executors and trustees fees can be paid on the same assets providing for an even more significant tax benefit.

Improper Beneficiary Designations. Many well-crafted estate plans have been undone by the improper designation of beneficiaries. For example, naming an estate as beneficiary of a retirement plan may result in the immediate incursion of the applicable income taxes which might have been deferred by an individual beneficiary. However, a spouse in a second marriage who designates the new spouse as beneficiary of insurance, loses the opportunity to direct that such funds ultimately go to children from the prior marriage - rather than the new spouse's new husband or children.

Investment of Assets in Unified Credit Trusts.

In most cases a unified credit (or "bypass") trust is created to reduce the overall estate tax burden of an estate. Because the assets of the trust will not be subject to any further estate taxes, the trust should almost always invest in growth assets which will create capital gains taxes. A trust is subject to the same capital gains rates as an individual. The growth is removed from the taxable estate and if distributions are necessary, they can be made at capital gains rates.

Removal of Trustees. The choice of trustees is one of the hardest decisions a taxpayer can make. Often it is the wrong choice. Pursuant to Revenue Ruling 95-58, 1995-2 CB 191, the beneficiaries of a trust can be given the authority to remove and replace a trustee, if the replacement trustee is not "related or subordinate" to the beneficiaries. Thus, a spouse of the grantor of an insurance trust can be given the power to remove trustees. Moreover, pursuant to Revenue Ruling 95-58, the grantor of a trust can be given the right to remove and replace a trustee, if the replacement trustee is not "related or subordinate" to the beneficiaries.

Holding Property as Joint Tenants with Survivorship. Although joint tenancy is used by many clients to avoid probate, it is often not a good planning tool. For example:

- If the assets pass to the surviving owner, there is no ability to pass such assets in a manner which may reduce taxes or which may provide for the proper disposition of the asset (e.g., through a Q-TIP trust).
- If the survivor takes the asset in fee simple ownership, there is no ability to protect the asset from creditors - instead the asset could have been placed in a spendthrift trust which restricts creditor claims.
- If the asset passes to the survivor, it is clear that marketability discounts for lack of control and marketability will not apply. Such discounts might apply if the asset were owned as tenants in common.
- A trust cannot be funded with the joint tenancy assets, restricting the ability to properly plan for minors, disabled beneficiaries, and financially troubled beneficiaries.
- In most states financial accounts in two names are deemed to automatically pass to the surviving party. Under the new disclaimer regulations (T.R. Section 25-2518-2(c)(4)) a survivor is allowed to make a disclaimer up to 9 months after a joint owner's death. However, the survivor cannot disclaim any portion of the account which was contributed by the survivor. This rule can create problems for taxpayers who do not focus on its restrictions. If both owners place equal amounts in the account, the survivor must still be able to prove to the IRS the source of the funds - record keeping will be critical because the taxpayer bears the burden of proof. Moreover, if the survivor established a joint account with the intent of using it to fund the unified credit of the other owner (e.g., husband places \$1.2 million in a joint account with his wife - intending to disclaim her interest if she died first), the unified credit may not be available.

Failure to Plan for the Proximate Death of a Beneficiary. Many well-planned estate plans have gone awry because the drafter failed to account for the proximate death of the beneficiary. For example, a single parent's will provides that if she dies all assets are paid to her only child. The parent dies immediately in an accident which causes the death of the child the next day. Unless the parent's will contemplates the child's proximate death, the parent's assets may ultimately go to the other (often estranged) parent of the child by operation of intestacy law at the child's death.

Summary

This article has discussed only a few of the often-overlooked opportunities and traps for the estate planner. Only a through discussion with the client will produce a understanding of the facts which determine the proper planning approach.

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