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Committee on Finance

Federal Estate Tax — Uncertainty in Planning Under the Current law

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Testimony
of
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CONRAD TEITELL

PRACTICING LAWYER AND PROFESSOR OF LAW

Conrad Teitell is a principal in the Connecticut- and Florida-based law firm of Cummings & Lockwood, resident in the firm's Stamford office. He is an adjunct professor (Masters Graduate Program in Estate Planning) at the University of Miami School of Law. He holds an LL.B. from Columbia University Law School and an LL.M. from New York University Law School.

LECTURER

He has lectured nationally on taxes and estate planning for thousands of hours at programs sponsored by bar associations, estate planning councils, colleges, universities, law schools, community foundations, hospitals, religious, health, social welfare and other organizations.

AUTHOR

His publications on taxes, wills and estate planning have been read by millions—lay people and professional tax advisers. His many articles include columns in *Trusts & Estates* magazine and the *New York Law Journal*. He is the editor and publisher of *Taxwise Giving*, a monthly newsletter and is the author of the five-volume treatise, *Philanthropy and Taxation*. His column, *Speaking and Writing*, has appeared in the American Bar Association's *Journal* and in *TRIAL*, the magazine of The Association of Trial Lawyers of America.

A SPEAKER'S SPEAKER

Conrad Teitell founded and teaches the American Bar Association's (ALI/ABA's) public speaking course. He also teaches public speaking to other professional advisers and laypeople. He teaches public speaking in a six-part PBS television series.

TELEVISION AND RADIO

Teitell was the on-air tax adviser for the PBS series ON THE MONEY produced by WGBH/Boston. He has done six PBS television specials on taxes and estate planning— two produced by WGBH/Boston, two produced by KVIE/Sacramento, one produced by WMHT/Schenectady and one produced by KCTS/Seattle. He is a commentator on National Public Radio's *Marketplace.*

OTHER STUFF

Conrad Teitell, the subject of three lengthy interviews in *U.S. News & World Report*, is regularly quoted in such publications as *The New York Times, The Wall Street Journal, The Los Angeles Times, Newsweek, Money Magazine*, and *Forbes Magazine*. Profiled in *Bloomberg Personal Finance* as one of the nation's lawyers who has reshaped estate planning by helping clients protect wealth, avoid taxes and benefit charities, he is listed in *The Best Lawyers in America, Who's Who in the World, Who's Who in America* and *Who's Who in American Law*. He has been awarded the designation "Distinguished Estate Planner" by the National Association of Estate Planners and Councils. He is a fellow of the American College of Trust and Estate Counsel and the recipient of the *American Law Institute/American Bar Association's* Harrison Tweed Award for Special Merit in Continuing Legal Education.

OPENING REMARKS

Mr. Chairman, Mr. Ranking Member, Members of the Committee:

I am Conrad Teitell, an estate planning lawyer with Cummings & Lockwood in our firm's Stamford, Connecticut office. Over 50 of our firm's lawyers are involved in estate planning. And I teach this stuff at a law school.

In *Gone with the Wind,* Margaret Mitchell observed that death, taxes and childbirth never come at a convenient time. Nor, she might have added, at a time certain.

This Committee has asked me to talk about the uncertainty in estate planning under current law — the one that Congress gave birth to in 2001. As all but troglodytes know, that law has a roller coaster estate tax exemption: $2 million this year and next; increased to $3.5 million in 2009. Then there is no estate tax whatsoever in 2010.

But the estate tax is scheduled to reappear in 2011 and thereafter in all its glory. And the exemption will be limited to $1 million.

So, the only convenient time for death and taxes is 2010 — at least for the heirs.

We have complex tax laws because those laws reflect our complex society. However, it's not the complexity that presents the problem with the current estate tax rules, but rather the uncertainty. And to cope with that uncertainty, we lawyers must often make complex plans even more so.

As I said a moment ago, I've been asked to talk about the complexities in planning under the current law — not whether estates should be taxed and if so with what exemption and at what rates.

My written statement for the record details the many problems under the current law that individuals face when trying to plan their estates. To name just a few:

- Complicated trusts often have to be created to deal with the moving-target-estate tax exemption. And we have to draft for the contingency that there won't be an estate tax in 2010;

- Life insurance planning to pay for estate taxes and provide liquidity is difficult; and

- Putting off decisions until Congress acts can be hazardous to your wealth.

Before I get back to the negatives, let me accentuate the positive — charitable bequests. This is the one area where it is easy to plan and draft under current law. The estate tax charitable deduction is unlimited, as it has been under our estate tax laws for almost 100 years.

Thanksgiving is just around the corner. Every year my family has a marathon Monopoly game — over the entire holiday weekend.

This year, to make the game more realistic for my grandchildren, I've indexed the game for inflation.

If you buy Park Place, it will cost you $5 million.

The card that formerly said "Pay Tax Collector $200" will now say: "Pay $20,000 if you land at 7:00 or 8:00 o'clock; pay $15,000 if you land at 9:00 o'clock; and pay nothing at all if you land at 10:00 o'clock. But if you land at 11:00 o'clock or later, pay $40,000."

That's analogous to the changing estate tax exemption over the next couple of years, complete repeal of the tax in 2010, but a return of a $1 million exemption in 2011 and beyond.

My version of the rules will surely make our Monopoly game more interesting.

But our nation's estate tax rules shouldn't be a roll of the dice!

DEATH AND TAXES ARE CERTAIN — THE ESTATE TAX SHOULDN'T BE ARBITRARY

The arithmetic. An individual who dies on December 31, 2008 leaving a $5 million taxable estate to his or her children will pay an estate tax of $1.35 million. If the same individual survived one more day — until January 1, 2009, when the exemption from the estate tax is scheduled to increase from $2 million to $3.5 million — the tax on the same estate will be $675,000. But if the individual had survived for another year — until January 1, 2010, when the estate tax is scheduled to be eliminated — the estate would not pay any tax. Finally, if the estate tax exemption returns to $1 million in 2011 and beyond the estate would pay a tax of approximately $2 million.

To paraphrase Rodney Dangerfield. The fact that the same size estate can have four different tax liabilities — depending solely on dates of death that could potentially be separated by only a few minutes — is not lost on taxpayers. This creates a lack of respect for a tax system and strikes taxpayers as arbitrary. And a lack of respect for the estate tax system can also breed disrespect for the gift and income tax laws.

BASIC ESTATE PLANNING IS MIND-BOGGLING FOR MARRIED COUPLES AND FAMILIES

The estate planning process. In helping clients plan their estates, we first discuss their wishes and their needs, capabilities and other information about the desired beneficiaries; and, of course, the client's assets. That's the easy part.

Then the talk turns to the federal estate tax exemption. The amount that a client can leave to his or her beneficiaries without incurring estate tax is a cornerstone of many estate plans. We explain that the amount has increased over the years, that it was only $600,000 ten years ago, but has gradually increased to its current level of $2 million. We also describe the future scheduled changes in the estate tax: an increase in the exemption to $3.5 million in 2009; repeal of the estate tax in 2010, and then the estate tax's rebirth in 2011 and thereafter with an exemption of $1 million.

We explain the conventional wisdom among estate planning lawyers is that the changes to the estate tax scheduled to occur in 2010 and 2011 are unlikely to occur, but that we must assume that they will in our planning.

Uncertainty about the amount of the estate tax exemption can have unfortunate consequences:

- Estate plans for married individuals with combined estates between $1 million and $2 million currently are far more complicated than may be necessary. Take the case of a married couple with combined assets of $1.2 million. Given the current value of the couple's assets and the current estate tax exemption of $2 million, those clients should have the flexibility to leave their estates to whomever they choose in whatever manner they wish without paying any federal estate tax. However, the possibility that the exemption from the estate tax might be as low as $1 million in 2011 and thereafter means that the Wills for this married couple must be designed to preserve the estate tax exemption of the first spouse to die by segregating the exemption in a trust for the benefit of the surviving spouse which will be exempt from the estate tax on the death of the survivor. Otherwise, if the property were simply left outright to the surviving spouse, an estate tax of 45% will be incurred on the survivor's death on the portion of the estate that exceeds $1 million, resulting in a federal estate tax bill of $90,000. Yet if we could inform the same couple with certainty that the exemption from federal estate tax is unlikely to return to an amount lower than its current $2 million level, we could advise them that a trust for the benefit of the survivor is unnecessary. In short, many couples are receiving more complicated — and costly — estate plans than they are likely to require.

- Because of the uncertainty in the exemption amount, couples must constantly update their estate plans, and incur additional legal fees, to respond to the scheduled changes.

- The expectation of the average estate planning client is that he or she can sign a Will and related estate planning documents, title assets in accordance with the plan, and return to their estate planning lawyer in five to ten years to assure that the plan remains appropriate in light of then-owned assets and any changes in family circumstances. However, the changes scheduled to occur over the next few years require many individuals to review their estate plans yearly. For example, a married couple with $2 million of assets in the husband's name and only modest assets in the wife's name would need very simple Wills to assure that they pass their entire inheritance tax-free to their children in 2007. However, if that same couple does not revisit the manner in which they hold title to their property in 2011 when the exemption from the estate tax is scheduled to return to $1 million, and the wife predeceases the husband during 2011 without using her $1 million exemption from the estate tax, their Wills drafted in 2007 could result in an estate tax of over $500,000. Sometimes as estate planning lawyers we can, by drafting "disclaimer" provisions in the documents, enable a survivor to take some post-mortem tax-saving actions.

- It is unfair to create this trap for individuals who have conscientiously tried to create tax-efficient estate plans, but haven't kept abreast of the complex changes to the estate tax exemption over time.

CONFUSION REGARDING THE ROLE OF LIFE INSURANCE

Life insurance has traditionally played an important role in estate planning. The uncertainty regarding changes in the estate tax makes it difficult for taxpayers to accurately evaluate the role that life insurance should play in their estate plans.

The proceeds of a life insurance policy are includable in the estate of the policy's

owner. Thus when a client is selecting an asset to give to children during his or her life, life insurance is a desirable asset. It is generally not very valuable during the client's life, but will be highly valued at the client's death. A common estate planning technique involves placing a life insurance policy on the life of a taxpayer into an Irrevocable Life Insurance Trust. That trust enables a taxpayer to take advantage of his or her ability to make annual tax-free gifts of up to $12,000 to each member of his or her family each year by making gifts to the trust for their benefit, and thereby provide funds to pay the premiums on the policy owned by the Insurance Trust. That trust's insurance proceeds will pass to the family members at the taxpayer's death without being exposed to the estate tax in the taxpayer's estate.

Life Insurance Trusts have been an important tool in estate planning not only because they can be coordinated with the gift tax rules, but also a life insurance policy that is payable to a Life Insurance Trust for a taxpayer's family provides an excellent source of liquidity at the taxpayer's death. This source of liquidity can prove helpful to a family needing funds that can be used to replace lost income, pay estate taxes or give the family a source of funds that can be used while a home or business is being sold.

Under the current $2 million estate tax exemption, a married couple with $5 million of assets can assure that the first $4 million of their assets pass to their children without exposure to the estate tax by having properly drafted Wills that take advantage of both of their $2 million exemptions from the federal estate tax. The remaining $1 million will be subject to the federal estate tax, resulting in a tax of $450,000, and a total inheritance of $4.55 million for the children. This couple might decide to purchase a $450,000 life insurance policy that will be payable upon the death of the survivor of them and place that life insurance in a Life Insurance Trust for their family. This way, if both spouses die at a time when the estate tax exemption is still $2 million for each individual, the $450,000 of life insurance proceeds would replace the $450,000 of estate tax due, resulting in the children receiving $5 million.

This planning, which has been very common, is often a victim of uncertainty. A married couple with $5 million and properly drafted Wills would not need a Life Insurance Trust in order to maximize the inheritance of their children in 2009. The individual exemption of $3.5 million that year will mean that a married couple can protect up to $7 million using simple Wills. A Life Insurance Trust would also prove unnecessary for this couple if they both die in 2010, when the estate tax is scheduled to be repealed. However, in 2011 and thereafter, when the estate tax exemption is scheduled to return to $1 million, a married couple will only be able to protect the first $2 million of their estates using their exemptions. If this comes to pass, a much larger life insurance policy might have been advisable.

Certainty regarding the future of the estate tax would eliminate the confusing variables that currently face a taxpayer who is evaluating the role of life insurance in his or her estate plan.

POTENTIAL INCAPACITY AND DELAY RESULTS IN UNFAIR TAX EXPOSURE FOR TAXPAYERS

"Let's see what happens" — the under-planning trap. While some individuals may end up over-planning their estates due to the uncertainty in the estate tax laws, many others under-plan. They defer important estate planning decisions until there is more certainty about the size of the estate tax exemption and the applicable rates. This failure to plan today may result in a significant and unfair future tax bill.

The current planning environment. Some married couples with less than $2 million in combined assets conclude that the exemption is likely to remain at or above its current $2 million level so that they can leave all their assets to the surviving spouse without estate tax exposure on the death of the survivor. But, as already discussed, any married couple with a combined estate in excess of $1 million is at risk of paying estate tax under the current tax regime when the property passes to their children. Estate planners, even if they have the opportunity to meet with those couples, are caught between Scylla and Charybdis when deciding whether to risk over-planning clients' estates or under-planning the estate and hoping for the best.

Lifetime gifts. A common estate tax reduction strategy is giving property away during the taxpayer's life so that it is not part of his or her estate at death. Giving to reduce estate taxes and to benefit family members and others before the giver's death is recognized and encouraged in the Internal Revenue Code. The law allows individuals to make the following gifts without incurring any gift tax: unlimited gifts to charity; unlimited gifts to U.S. citizen spouses; limited gifts to non-citizen spouses; annual exclusion gifts of $12,000 per year per donee; gifts to pay medical and educational expenses; and gifts of up to $1 million during the lifetime of the taxpayer.

While giving has always been a popular strategy for the wealthy, it can also benefit individuals with more modest estates. However, the current estate tax environment has caused individuals who would otherwise engage in appropriate giving programs to forego or postpone giving, thereby potentially losing the benefit of reducing their taxable estates by both the value of the gifted property and the future appreciation on that property.

Of particular import is the decreased use of the $12,000 annual-per-donee-gift-tax exclusion for taxpayers who are on the border of having taxable estates. Annual exclusion gifts can be made each year to the same individuals, or to certain types of trusts for their benefit.

The failure to make the annual exclusion gift in a particular year has a significant opportunity cost associated with it. For example, a single taxpayer can give $12,000, and a married couple $24,000, to a child each year. If the married couple fails to make this

$24,000 combined annual exclusion gift to just one child in just one year, the opportunity cost of this failure could be as much as $12,000 in federal estate tax, assuming an estate tax rate of 50%.

Gifts beyond the annual exclusion. Wealthier individuals are postponing the decision to make larger gifts which may result in the payment of significant federal gift tax because they have concluded that they do not wish to pay a gift tax now if the property may not be subject to estate tax in the future. In the meantime, family members may be deprived of gifts that could enable them to buy homes or start businesses before the parent's death.

Future planning may be impossible. The understandable decision to defer planning for the estate tax (waiting to see what happens) assumes that the taxpayer will have the capacity to plan in the future. A client who postpones making important changes in his or her will in order to avoid the expense of having to redo it after the estate tax law is revised will not have an opportunity to make those changes if he or she loses mental capacity before Congress finally acts.

Uncertainty regarding future estate tax laws is creating two classes of families who will be punished for their failure to act while waiting for Congress to act. First, the families of taxpayers who became mentally incapacitated and, as a result of their incapacity, are unable to implement estate planning techniques that would minimize the impact of the estate tax on their inheritance. Second, the families of taxpayers who wanted to see the future of the estate tax law before engaging in a gifting program and, as a result, missed opportunities to make gifts that would have minimized the exposure of their assets to the estate tax

CHARITABLE BEQUESTS

Outright charitable bequests. Fortunately, this is one area where it is easy to plan and draft under current law. The estate tax charitable deduction is unlimited. So for outright bequests to qualified charities, no estate tax is payable regardless of the size of the bequest. Thus whether the estate tax exemption is $2 million, $3.5 million or higher is irrelevant. Donative intent, of course, is crucial.

IRAs to charity at death. Many individuals give all or part of their IRAs and other pension plans to charity at death. Those gifts qualify for the unlimited estate tax charitable deduction.

Retirement plans payable to individual beneficiaries (instead of charity) at death. The changing estate tax exemption (and estate tax repeal for 2010) must be taken into account in planning and drafting. There can be a double tax (even triple tax if the generation-skipping tax is involved) if a retirement plan is given to a beneficiary other than a charity. In addition to the estate tax (and the generation-skipping tax in some cases), the beneficiary must pay income tax on so-called income in respect of a decedent. However, if the IRA or other pension plan is given to charity, the estate tax (and the generation-skipping tax if otherwise applicable) and the income-in-respect-of-a-decedent tax are avoided. This benefits charities and those that they serve.

Before 2006 an individual who used funds from his or her IRA to make lifetime charitable gifts was taxed on the funds payable to charity. For nonitemizers, there was no offsetting charitable deduction. And for generous higher-income donors, the income tax charitable deduction was often limited or unavailable because of the adjusted gross income ceilings on deductibility—even taking the five-year carryover into account.

For 2007 (and last year) an individual age 70½ or older can make direct charitable gifts from an IRA (including required minimum distributions) of up to $100,000 per year to public charities (other than donor advised funds and supporting organizations), operating private foundations and "conduit" foundations and not have to report the IRA distributions on his or her federal income tax return.

The Public Good IRA Rollover Act of 2007 (S. 819) with lead co-sponsors Senator Byron L. Dorgan (D-ND) and Senator Olympia J. Snowe (R-ME) has bipartisan co-sponsorship on the Finance Committee and in the Senate. An identical House bill (H.R. 1419) has bipartisan co-sponsorship in the House and the Ways and Means Committee.

Those bills would expand the current IRA/charitable rollover provisions in a number of ways, the most significant for many charities and their supporters would allow a tax-free rollover for a life-income plan (e.g., gift annuity, charitable remainder unitrust) for individuals age 59½ or over. The tax-free direct charitable rollover (as under current law) would be available for individuals age 70½ or over.

Charities are grateful. I am the pro bono legal counsel for the American Council on Gift Annuities (an organization of 1,200 charities nationwide). Those charities are grateful to the Congress for the existing IRA/charitable rollover law and that Congress is considering extending that law. Adding the ability for an individual to roll over part or all of an IRA to charity and receive life income (fully taxable) from a life-income plan would enable millions of taxpayers of modest and average means to benefit our nation's charities and the people they serve. Instead of getting income from their IRAs, they would get income from a charity's life-income arrangement. Currently, about two-thirds of the taxpayers take the standard deduction. This would give them a tax incentive to benefit charities and still provide them with retirement income.

Testamentary charitable remainder unitrusts and charitable remainder annuity trusts (CRTs). Under current law, where a testamentary CRT provides income payments to a survivor for life with a remainder gift to a charity, the charitable gift element is fully deductible under the unlimited estate tax charitable deduction. The value of the life-income interest for a survivor is potentially subject to estate tax. So it is often a challenge to plan not knowing when death will occur and what the estate tax exemption will be (or whether there will be an estate tax).

Testamentary charitable lead unitrusts and lead annuity trusts that make payments to a charity for a period of time with an eventual gift to family members. The remainder gift of the lead trust to family members is subject to the estate tax. Thus the changing estate tax exemption (and whether there will be an estate tax at the time the lead trust is created by an individual's will) has created planning and drafting challenges.

Putting all this in context. An incredibly large number of generous Americans — of modest, average, and wealthy means—include charities in their estate plans. I know this from my law practice (working with both charitable institutions and individuals in their estate planning) and my work with a number of national umbrella organizations of charities. And, of course, published statistics show the magnitude of charitable giving. From the very beginning of our income, gift and estate tax laws, almost 100 years ago, those laws have encouraged charitable contributions. Any new estate tax law should continue to provide for an unlimited estate tax charitable deduction.

THE IMPACT OF CHANGING A TAXPAYER'S DOMICILE

Our firm advises hundreds of clients who have residences in both Connecticut and Florida. Connecticut has decoupled from the federal estate tax system and created a separate Connecticut estate tax, while Florida has no state estate tax. Our attorneys often meet with clients who have residences in both states and we discuss the estate tax advantages of establishing Florida as their domicile.

Many clients have taken the steps required to transfer their domicile from Connecticut to Florida. Although it is usually clear when a client should consider changing domicile to reduce the estate tax burden on his or her estate, it is a decision that comes with collateral consequences. A taxpayer who decides to move his or her domicile to Florida to avoid the Connecticut estate tax at death is no longer going to pay Connecticut state income taxes or sales taxes.

Because a person's domicile is based on many factors, the domicile claimed by the executor of a decedent's estate may be disputed by one or more states taking a contrary position in order to collect state death taxes. The huge dollar amounts that will be at stake as a result of domicile disputes will undoubtably lead to costly litigation.

COMPLEXITY AS A RESULT OF STATES "DECOUPLING" FROM THE FEDERAL ESTATE TAX SYSTEM

Intertwining of federal and state tax laws — the problem. My office at Cummings & Lockwood is located in Stamford, Connecticut, where the Connecticut estate tax exemption is $2 million — the same as the current federal estate tax exemption. Our firm also has two Florida offices. That state does not have a state estate tax. The states which border Connecticut and in which some clients have vacation homes all have a state estate tax system. The exemptions from the state estate taxes of New York, Rhode Island and

Massachusetts are, respectively, $1 million, $675,000 and $1 million.

When Congress revised the estate tax law in 2001, that revision gradually eliminated the "state death tax credit." That credit effectively created estate tax revenue sharing between the federal government and the states. With the repeal of the credit, the states lost that revenue source. The states responded to this lost revenue in a number of ways. Some states, like Florida, have elected against implementing a state estate tax. Other states, like my home state of Connecticut and the other states in the area, have "decoupled" from the federal estate tax system, creating an independent tax system with an exemption amount which may match the federal exemption (as in Connecticut), but frequently does not (as in New York, Massachusetts and Rhode Island).

This "decoupling" from the federal estate tax system has had unexpected and significant tax consequences for our clients whose estate plans were designed to avoid federal estate tax. When the federal and state estate tax systems worked together, a Will designed to avoid federal estate tax would also be effective to avoid state estate tax. Not anymore.

Because of this significant change, our law firm contacted every one of our estate planning clients to bring this change to their attention. Our lawyers spent literally hundreds upon hundreds of hours figuring out how to revise our documents to take into account that the state exemption from the state estate tax might be lower than, higher than or equal to the exemption from the federal estate tax. And we have familiarized ourselves with the estate tax systems of other states, and encourage our clients to retain attorneys in other states to determine whether assets outside of our client's primary state of residence will be exposed to a state estate tax.

This is a challenge for our law firm even though we have more than 50 estate planning lawyers. We have the person power to familiarize ourselves with the estate tax systems of other jurisdictions, coordinate our response to our clients and update our firm's drafting system. It is difficult to imagine how a solo practitioner who does some estate planning could adequately understand all of the planning issues that arise out of a state's decision to decouple from the federal estate tax system, communicate all of those issues to his or her estate planning clients and help a client with a vacation home in another state plan for the estate tax system in that state.

The response of the various states to the 2001 changes to the federal estate tax system has made effective estate planning drastically more complex — and costly.

THE REPEAL OF THE ESTATE TAX FOR 2010 MAY NOT BE ALL GOOD NEWS FOR TAXPAYERS: CARRYOVER BASIS (NOT STEPPED-UP BASIS) AT DEATH

A ticking tax bomb. In 2010, carryover basis applies to assets having over $3 million of appreciation inherited by a decedent's spouse, and assets having appreciation of more than $1.3 million inherited by others. The $1.3 million is the amount for all heirs combined, not for each heir. Inheritances below those amounts are governed by the current stepped-up basis rules. These carry-over-basis rules apply for 2010 only; in 2011 and beyond the current stepped-up basis rules will apply.

Tax Reform Act of 1976—the ancient history. That law provided for a carryover basis instead of a stepped-up basis at death. Apart from the dissatisfaction with a rule that imposed a new tax (capital gains when an heir sold inherited assets), myriad outcries were heard by Congress that it was impossible to comply with the new rules. Congress retroactively repealed the carryover-basis rules to the date of The Act's enactment.

Back to the present estate tax law — added complexity and costs to client. It is possible to draft estate plans to maximize the limited step up in basis (described earlier) and bequeath — if death occurs in 2010 — the most highly appreciated assets to charities (if one is planning charitable bequests). For charities, basis is generally irrelevant because only in rare cases do they pay capital gains taxes on the sale of appreciated assets. The least appreciated assets are bequeathed to family members. Planning becomes more difficult in determining which heirs will get the lower basis assets and which heirs will get the higher basis assets. The heirs will pay differing capital gains taxes on subsequent sales of their inheritances. Some of them will have bad heir days.

What's happening on the ground? Most planners, I understand, are ignoring the issue. They believe that the carryover basis rules will never come to pass. Thus the general attitude is "wait and see." Of course, if the client is mentally incompetent in 2010, planning opportunities could be lost if carryover basis becomes a reality.

PLANNING FOR INTERESTS IN QUALIFIED RETIREMENT PLANS: IRAs, 401(k)s, 403(b)s AND SEPs

The estates of many individuals are comprised of interests in retirement plans and those plans represent a large percentage of their overall net worth. As a result, estate planners must consider those assets when preparing a tax-efficient estate plan. The use of trusts are often involved to hold an individual's estate tax exemption amount and in planning for minor beneficiaries. As the size and importance of those retirement assets increases, so does the complexity in planning for their disposition under the current IRS regulations and rulings. They impose onerous requirements and seemingly arbitrary restrictions. The rules have become so complicated that trust planning with qualified retirement plans, which is absolutely necessary for spouses and minor children, is so complex that even the most sophisticated estate planning lawyers struggle with them.

HIGH-NET-WORTH INDIVIDUALS: ESTATE TAX CONCERNS AND PLANNING TECHNIQUES

Initial observation. While the amount of the estate tax exemption is of some interest, the overwhelming concern is the tax rates for the estate and generation-skipping taxes.

Testamentary planning techniques. The starting point is a testamentary estate plan that efficiently utilizes the estate and generation-skipping transfer tax exemptions, the marital deduction and the charitable deduction.

Lifetime techniques. Once the testamentary plan is in place, estate planning turns to lifetime giving strategies to remove assets from the estate and reduce the value of assets that will be in the estate.

- The use of lifetime gifts up to the annual exclusion amount is one way to give assets to various family members thereby reducing the assets in the individual's estate. Beyond that, any gifts (other than charitable donations) will either use the individual's $1 million lifetime gift tax exemption or generate a gift tax. Thus the strategy is to focus on ways to make lifetime gifts using as little of the exemption or generating the smallest amount of gift tax possible in each transfer; and also to leverage the gifts to remove as much value as possible from the taxable estate for each dollar of exemption used or tax paid.

- Estate planning for high-net-worth individuals focuses on identifying assets that have a lower value now than the individual expects them to have in the future, then transfer those assets now to the intended beneficiaries before the expected appreciation. Those gifts can be outright or in trust, and can employ strategies to further reduce the gift tax cost, such as making gifts to Grantor Retained Annuity Trusts.

- Gift transactions are structured so that for gift tax purposes the taxable value of the gift is less than the liquidation value of the gifted asset. A common technique is a Qualified Personal Residence Trust.

- Tax-efficient lifetime gifts are made by identifying assets that qualify for a valuation discount because of the nature of the assets' ownership — e.g., establishing a valuation discount based on a fractional interest, minority-interest, or lack of marketability.

When the tax man cometh. Depending on the nature of a high-net-worth individual's assets, estate planning can be as much about how to pay the taxes as how to avoid or minimize them. Because the estate tax is tax inclusive while the gift tax is tax exclusive, the same asset can be given during lifetime or at death with different total tax results. For some individuals, paying a gift tax now may be more tax efficient than having the estate pay an estate tax later. An estate planner's job is to identify the individual's ability to (1) make large taxable gifts, (2) pay taxes on those gifts and (3) structure those gifts in the most efficient way to limit the gift tax exposure.

The fly in the ointment. With the current uncertainty in the estate tax law, many individuals are reluctant to pay a gift tax now in order to avoid a larger estate tax later. They believe that there may be no estate tax when they die or if there is, the rates will be much lower. They fear that paying a gift tax now could be a foolish decision.

How to pay the estate tax. For some families, the issue is not when to pay the tax, but how. An estate that is high in value but lacking in liquidity can cause serious problems for the heirs who will be faced with a large tax due but difficulty paying that bill. This can lead heirs to sell estate assets quickly, with little ability to obtain fair market value for the assets. In those situations, the estate planner must work with the family to both reduce taxes and create strategies for liquidity at death. Those strategies may involve life insurance, buy-sell agreements, and complex structures.

CONCLUSION

A fable by the late Ambrose Bierce, American journalist and satirist, may be instructive.

An Associate Justice of the Supreme Court was beside a river bank when a Traveler approached and said:

> "I wish to cross. Will it be lawful to use this boat?"
>
> "It will," was the reply; "it is my boat."
>
> The Traveler thanked him and, pushing the boat into the water, embarked and rowed away. But the boat sank and he was drowned.
>
> "Heartless man!" said an Indignant Spectator. "Why did you not tell him that your boat had a hole in it?"
>
> "The matter of the boat's condition," said the great jurist, "was not brought before me."

When Congress enacted the current estate tax law in 2001, the matter of the uncertainty in planning that would result was apparently not brought before it.

Now that the matter has been brought to the Congress's attention by myriad taxpayers and their advisers, it is time to enact corrective legislation — and soon.