



Planning Based on Estate Size

Different Strategies Apply as Estates Increase in Size

By Robert L. Moshman

Estates of different sizes have entirely different concerns and utilize different strategies. While transfer tax concerns have long dominated estate planning, rising estate tax exemptions mean that "smaller" estates will not have estate tax as a primary concern. Yet the elimination of one set of concerns merely shifts emphasis to other issues.

But which estates are considered "small" or "large" these days? What "planning brackets" are applicable and what planning techniques should be considered? How will the potential repeal of the estate tax affect all this?

Planning Small

Confiscatory estate taxes have been a powerful motivator for estate planning. Estate tax rates rose to 77% as a result of World War II and remained at 55% during the final decades of the 20th century. Avoidance of transfer taxes had been a primary focus of estate planning for a long time leading up to the 2001 legislation that is phasing in the repeal of the federal estate tax.

Does a small estate still need to be planned if it is not subject to federal estate tax? Yes, for a variety of reasons. ¹

WASTE: A decedent's \$1 million estate is not planned, resulting in estate settlement delays. A family member who volunteers to serve as executor fails to invest assets effectively and gives a family heirloom to the wrong heir, resulting in a lawsuit. How much of a \$1 million estate can be exhausted by estate settlement delays, bad investment decisions, and a lawsuit? Ten percent? Twenty percent? More? When the estate is small to begin with, there is no money to spare; even a slight error can exhaust a significant portion of the estate.

ASSET PROTECTION: Why plan a "small" estate? James Sr., a widower, leaves an estate of \$500,000. Without a will or trust or even some basic post-mortem planning, the entire estate passes to his son, James Jr., whose creditors quickly seize the money. Neither James Jr. nor his heirs benefit from the money. Lifetime gifts from James Sr. to his grandchildren, a spendthrift trust, or the exercise of a disclaimer by James Jr. could have protected that \$500,000.

DYING TOO YOUNG: A young couple with young children has every reason to plan a small estate. A strategic estate plan can create an "instant estate" by using inexpensive term life insurance. The estate plan can arrange to have that insurance in a trust that can provide for the couple's young children.

FUTURE GROWTH: Who is to say that a small estate will remain small? An individual with a \$1.5 million estate may continue to earn and invest funds, inherit wealth, receive a large legal settlement, or experience a windfall.

THE UNEXPECTED: Mary did not have a will. She understood that if she died, her estate would be inherited by her daughter under state law. That was good enough for her. What she didn't know was how state law would distribute her estate in the event her daughter predeceases her. When told which relatives would inherit her wealth, she was shocked and dismayed!



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It is absolutely clear from these five categories that even a modest-sized estate can benefit from a basic estate plan. It is important to make sure that assets are invested properly, protected from exposure to creditors, and distributed in accordance with the individual's wishes.

Planning Big

Larger estates are not merely bigger than small estates; they are different. They include more diversified assets and face different tax consequences. Wealthy individuals also have different attitudes and expectations.²

It could be argued that a wealthy middle-aged individual in good health is considered statistically likely to survive the estate tax repeal scheduled for 2010. But estate tax repeals are not on Ben Franklin's short list of certainties. In fact, three previous American estate tax repeals were attempted in 1802, 1870, and 1902. Obviously, these repeals were not permanent.

Prudence requires planning a sizable estate as though it would be exposed to the federal and/or state transfer taxation that will apply prior to 2010. Planning must also anticipate multiple possibilities which include (a) estate tax repeal in 2010, (b) the return of a federal estate tax in 2011 under the Byrd rule; or (c) some future tax reform that alters the current path toward estate tax repeal.

Sizable estates may incur significant federal and/or state transfer taxation. Obviously, a good estate plan should try to minimize these tax consequences. With larger estates there may be assets such as appreciated stocks, real estate, and works of art that lend themselves to more sophisticated planning techniques:

- ☐ Lifetime gifts of appreciated property
- ☐ Irrevocable life insurance trusts
- ☐ Generation-skipping transfer tax trusts
- ☐ Family limited partnerships (FLPs)
- ☐ Qualified personal residence trusts (QPRTs)
- ☐ Philanthropy through charitable gifts of appreciated property, charitable remainder trusts, charitable lead trusts, and private foundations

Good planning for large estates goes well beyond saving taxes.

- ☐ If property has to be sold to pay taxes on time, valuable assets may be hurriedly sold at less than their true value and will be forever lost from the estate. A good estate plan earmarks adequate funding sources, such as life insurance, to pay taxes on time.
- ☐ Large estates may have specialized assets such as a business. Special attention must be devoted to such estates so that the business can continue to function after the owner's death.
- ☐ Special assets such as manuscripts, patents, antiques, collectibles, and works of art involve special considerations as well. An estate plan should anticipate valuation and insurance issues for such assets.



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- A sizable estate has assets that require supervision. If \$10 million of investments are not supervised effectively while an estate is being settled, the value of those investments can shrink considerably. That makes professional investment management a critical element to be included in the estate plan.

Planning in the Middle

One can say with a good deal of confidence that a very small estate will not face transfer tax issues. With federal estate tax exemptions of \$1.5 million currently and higher exemptions of \$2 million in 2006 and \$3.5 million in 2009, individuals with estates falling within the protection of these exemptions will feel much less pressure to engage in tax planning.

And one can be fairly certain that a very large estate will face taxation. But moderate estates, between \$1 million and \$5 million, face the greatest uncertainty about tax consequences. As a result, estates of this size are more unpredictable. They are right on the cusp of tax liability.

As these estates receive inheritances or shift in value due to stock market fluctuations, they go back and forth over the line of being taxable or not. The phasing in of higher estate tax exemptions will make things even more dynamic over the next five years. For example, a \$3 million estate would be taxable in 2008, but not in 2009.

While individuals with moderate estates are less likely to spend money on sophisticated tax planning, their heirs may be disappointed when an estate tax liability could have been avoided. They may want to hold estate-planning advisers accountable for the lack of tax planning. A good business practice for advisors, therefore, is to provide clients with tax-planning opportunities and document these efforts.

From a drafting perspective, it is possible to anticipate differing scenarios in 2005, 2006, 2009, 2010, and 2011, i.e., before, during, and after the repeal. A will could be drafted for the current tax laws as they would apply if a testator died in 2005, for example. However, the will could allow executors the flexibility to not utilize certain tax-oriented options.³

2005	2006	2009	2010	2011	
Exemption	\$1.5 million	\$2 million	\$3.5 million	n/a	\$1 million
Top Estate Tax Rate	47%	46%	45%	n/a	55%
SMALL					
\$1 million	\$0	\$0	\$0	\$0	\$0
\$3 million	\$695,000	\$460,000	\$0	\$0	\$945,000
LARGE					
\$10 million	\$3,995,000	\$3,680,000	\$2,925,000	\$0	\$4,795,000
\$25 million	\$11,035,000	\$10,580,000	\$9,675,000	\$0	\$13,404,000



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Recent Decisions

Disclaimer Causes Tax Deficiency

A will provided that if the surviving spouse disclaimed any portion of the estate, that that amount would be added to a trust. When the surviving spouse disclaimed certain securities, they were added to a trust which had already been funded with an amount equal to the "aggregate federal estate tax exemption equivalent." The additional assets caused the trust to exceed the exemption amount. A tax deficiency of \$147,800 was imposed. Estate of Katz v. Commissioner, TC Memo. 2004-166 (July, 2004).

Appointment Power and GST

Decedent left a family trust for the lifetime benefit of his two daughters. Trustees were to pay the trust's net income to the trust beneficiaries in equal shares. The daughters each had annual appointment powers, during their respective lifetimes, to appoint an amount equal to the annual exclusion to their own children. Along with this inter vivos appointment power, the daughters could, at their death, appoint a fractional portion of the trust principal to one or more of their descendants or to his or her estate.

If one of the children exercised the inter vivos or testamentary power for her own descendants, would the transferred assets be subject to the generation-skipping transfer tax? In a private ruling, the IRS ruled that transfers resulting from the exercise of the inter vivos power of appointment were transfers of the child's right to receive the income from the distributed property for gift tax purposes.

The daughters would be treated as the transferors. Transfers by the daughters to their own children would not skip a generation. Nor would transfers to a grandchild where the intervening generation is deceased. Since the beneficiaries were limited to children or children of a decedent's child, no distributions caused by exercise of the powers of appointment could reach a "skip" person for GST purposes. Letter Ruling 200427018.

A Grantor's Reimbursement

A grantor who retains control over a trust will end up having trust income included in his or her annual income for tax purposes. Where it is useful to shift tax liability to the grantor, trusts are designed to be "intentionally defective" so as to establish a grantor trust for tax purposes.

But what happens when a trust reimburses the grantor for income tax liability caused by the inclusion of trust income in the grantor's taxable income?

First of all, the grantor's payment of the income tax is not a gift; that is the grantor's liability. Second, the trust's reimbursement of the grantor is not a gift from the trust beneficiaries if the trust made it mandatory or discretionary to make such a reimbursement payment.

For estate tax purposes, the value of the trust is not included in the grantor's estate if neither the trust instrument nor applicable state law required the reimbursement to be made. That would mean reimbursement was not within the power or control of the grantor. Similarly, if reimbursement is made through the trustee's discretion, that is not within the grantor's control and does not cause the trust to be included in the grantor's estate. If, however, the reimbursement were mandatory, that would cause the trust to be included in the grantor's estate.



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The IRS indicated one other scenario with which to be concerned. Where reimbursement is discretionary but there is an "understanding" between the grantor and the trustee, that could constitute sufficient control to cause the trust assets to be included in the grantor's estate for tax purposes. Rev. Rul. 2004-64.

GST Exemption Allocation

A time extension was granted to allow a fiduciary to allocate the generation-skipping transfer tax exemptions of a deceased couple to the couple's inter vivos transfers to three irrevocable trusts. The fiduciary (a bank) had advised the couple's tax attorney to file gift tax returns. The returns were filed late and GST allocations were made based on the value of securities on the date of the transfer rather than the date of the tax return. The increased value of the securities caused transfers to exceed the allocated exemptions. . An extension of time to properly allocate the exemptions was permitted under Reg. §301.9100-3 because the couple relied on a qualified tax professional in good faith, and granting relief did not prejudice the interests of the government. Letter Ruling 200426003.

Technical References

- ¹ Koenig, "The World without Death Taxes", 140 *T&E* 7, p. 34 (July, 2001). Many articles such as this identify planning opportunities in the absence of the estate tax.
- ² Prince and Grove, "Yes, the Rich are Different", 142 *T&E* 2, p. 49 (Feb., 2003).
- ³ Jurinski, "Planning for the Medium-Sized Estate Presents Special Challenges", 30 *EP* 8, p. 398 (Aug., 2003).



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