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Seven Surprising Scenarios

By Robert L. Moshman, Esq.

Given the twin certainties of death and taxes, would it be unreasonable for a mortal, faced with the task of setting his or her affairs in order, to at least have a reliable set of tax rules to live by…and die by?

A key advantage of financial planning or estate planning is to arrange assets in a favorable configuration based on an existing set of rules. Advance planning can exploit both the rules and the time value of money.

But when the rules of the game change, all the benefits of planning may be negated. Here we identify seven surprising scenarios.

If there are seven surprises out there, then there are also seven types of estates that will be affected and these estates will need to make adjustments now (if that is even feasible) or, more likely, look to a bag of tricks for a strategic response when there is very little time to work with.

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Phasing In Transitions

The tax code is an ever-changing tableau, a restless ocean that absorbs wave after wave of creative overhauls, reforms, and technical corrections.

Despite all the dramatic changes to the system of transfer taxation in the United States over the past 50 years, there has never been a time of such total uncertainty as right now. The range of possibilities include:

a) the current rules,

b) termination of the estate tax,

c) the return to 2001 rules, or

d) something completely different.

Previous Transitions

We've faced major changes before. For example, the arrival of the generation-skipping transfer tax in 1986 was a significant change. But that one made a lot of noise coming.

There was a false start in 1976 when the GST was actually enacted but then crashed and burned in a series of embarrassing setbacks where it was postponed from taking effect, then amended three times, and finally repealed ignominiously, as if it had never taken place.

It was as if the tax scientists had blown up their laboratory, poked their frazzled heads out, and said, "Let's pretend this never happened." Not very subtle.

Phase-ins: Other changes have been phased in with a series of discreet steps. This presents a bit of a moving target, but at least there are rules that can be anticipated.

For example, when the Tax Reform of 1976 combined the estate and gift tax systems, a unified credit of $30,000 replaced a $60,000 estate tax exemption and a $30,000 gift tax exemption. The new $30,000 credit was initially to be increased each year until it reached $47,000 in 1981:

YEAR	Unified Credit	Exemption Equivalent
1977	$30,000	$120,667
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981+	47,000	175,625

But then the Economic Recovery Tax Act of 1981 arrived and extended the phase-in for an additional six years:

YEAR	Unified Credit	Exemption Equivalent
1982	$ 62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987	192,800	600,000

And that's where we stayed for 11 years, 1987 through 1997. Then came the Taxpayer Relief Act of 1997, which aspired to exempt up to $1 million of estates by 2006. The path it offered between the exemption equivalent of $600,000 to $1 million entailed another nine years of phase-ins.

Incidentally, the 1997 act was a turning point; for the first time, the tax code was expressed in terms of what the exemption amounts were worth and required the actual credits to be calculated.

However, the transition was to be very conservative. Under this phase-in plan, had it been followed, the unified credit would have inched up for six years and would still have an exemption equivalence of $700,000 in 2003, deferring 75% of the intended increase until the last few years of the phase-in schedule:

YEAR	Unified Credit	Exemption Equivalent
1997	$192,800	$ 600,000
1998	202,050	625,000
1999	211,300	650,000
2000	220,550	675,000
2001	220,550	675,000
2002	229,800	700,000
2003	229,800	700,000
2004	287,300	850,000
2005	326,300	950,000
2006	345,800	1,000,000

By 2001, the unified credit, aka "applicable exclusion amount," had taken 15 years to get from an exemption equivalent of $600,000 to $675,000.

Was impatience with the slow phase-in a factor in the sweeping estate tax repeal sought by the Economic Growth and Tax Relief Reconciliation Act of 2001? EGTRRA modified the previous chart after 2001:

YEAR	Exemption
2001	$ 675,000
2002	1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000

EGTRRA accelerated the $1-million exemption level so that it arrived in 2002 instead of 2006 and then increased the exemption in stages leading to total repeal. This projected path departed from the long highway of small incremental changes and takes a quantum leap into the great unknown:

YEAR	Exemption
2006	$2 million
2007	2 million
2008	2 million
2009	3.5 million
2010	[REPEAL]
2011	1 million

Other Surprises From Congress

On occasion, Congress has attempted to defy time and space with retroactive tax changes that made it impossible for taxpayers to react at all.

Courts have looked askance at retroactivity to the extent such changes apply to decedents. This is a class of taxpayers who don't have flexible options such as coming back to life and moving assets around to cope with retroactive tax laws.

Even without retroactivity, tax law changes just before an individual's death can be just as damaging to an estate plan. For many individuals, there may be little time to make adjustments between a tax change and death.

Another consideration is the wisdom of forcing someone to make important decisions in such a proactive manner while in the last stages of life, perhaps in poor health and/or with diminished mental comprehension of the consequences.

That's not fair! But that's the challenge facing estates right now. There are several plausible ways the transfer tax system could take shape over the next five years. Here, we've focused on seven of these scenarios, consider which estates need to be aware of such changes, and take note of what tools may be available to do something about it.

Scenario #1: The Frozen Plateau

You are marching along through a series of tax changes that are being phased in when, suddenly, Congress gets cold feet and decides to put everything on ice. Suddenly, it's the big freeze. Time stops.

Congress can stop time. They've done it before. When there were misgivings about the carry-over basis in 1976, Congress postponed the change, puzzled over it, and finally abandoned the idea in 1980.

In 1981, ERTA called for the top estate tax rate to drop from 55% to 50% in 1987. But when 1987 arrived, that reduction to 50% was postponed again.

For our purposes, this example could mean a stoppage in play at any time in the game. But a plausible case can be made for the $2-million exemption that will be arriving on January 1, 2006:

1) A $2-million exemption shields more than 99% of all estates from any estate tax.

2) The $2-million plateau is scheduled to remain in place for three years: 2006, 2007, and 2008. This will give an impression of stability that will resist further change through sheer inertia.

3) There are several elections before 2009 (when the exemption is supposed to jump to $3.5 million). If the balance of power shifts in Congress or the White House, the repeal of the estate tax will be stopped. Following the path of least resistance would mean freezing the exemption right where it is after the 2008 election, i.e., at $2 million.

Surprise Factor: Obviously, any estate over $2 million would have its work cut out for it. A marital estate of, say $5 million, has some leeway because of the unlimited marital deduction.

Strategy: After the death of the first spouse, the surviving spouse could make lifetime gifts if the exemption amount stayed low.

Scenario #2: The $3.5-Million Precipice

Do people with shy and retiring personalities and small egos run for Congress? Do any of the people we send to Washington enjoy the drama of a last minute change?

Count on it. Congress will enter the picture in the final hour like FBI agents trying to defuse a bomb with one second left on the timer.

In this context, the last chance to take action would be 11:59 p.m. on December 31, 2009, just before the estate tax vanishes. The net effect could be to leave the exemption amount at $3.5 million.

Surprise Factor: Obviously, this drama is of academic and philosophical interest to the vast majority of estates. Less than 1% of estates are taxable with current exemptions of $1.5 million. Not many people will feel too sorry for someone with an estate of $20 million or more, but the large estate which relies exclusively on estate tax repeal could have a sudden problem in 2010.

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Strategy: Stopping short of complete repeal at the last minute will put a great deal of pressure on estates to alter values. Family limited partnerships, life insurance, and disclaimer trusts should be considered.

Scenario #3: Total Repeal

Congress goes into emergency session and filibusters involve readings from the phone book, the Tax Code, and *The Gulag Archipelago,* Aleksandr Solzhenitsyn's three-volume memoir of the Soviet Union's prison camp system. When the sun rises on January 1, 2010, and a stalemated Congress has failed to act, the estate tax is repealed!

Surprise Factor: This is the one part of the estate tax repeal that experts have unanimously thought was the least likely to be implemented, i.e., the repeal itself. The moment the repeal arrives, opponents will commence work on repealing the repeal.

Strategy: Making plans in anticipation of some estate tax remains a prudent approach even if repeal does arrive on schedule or sooner.

Scenario #4: Déjà Vu, I See You

It is January 1, 2011, and members of Congress, after 365 days of posturing and filibustering, lay sprawled and unconscious throughout the Capitol, allowing the sun to rise on the most improbable of scenarios, a reversion, back through time, to the way things were in 2001.

Hello, there's a blast from the past...it's the $1-million exemption. And there are our old friends, the top estate tax rate of 55% and its little sidekick, the 5% surtax on larger estates.

Surprise Factor: Few experts predicted that we'd reach the repeal in 2010 and fewer still expect us to revert to 2001 rules in 2011, yet that is exactly what is on the books until Congress takes action.

Scenario #5: Carry Over, Carry On

While all the attention is on the repeal of the estate tax and all that the estate tax represents, there is another tax that may be far more important to many estates. Significant capital gains on appreciated assets held at death would be subject to tax under the proposed rules taking effect in 2010. Right now that rate appears to be 20%, but that could change.

Surprise Factor: If the stepped-up basis were replaced in 2010 by a carry-over basis that continues to allow a limited stepped-up basis of $3 million plus $1.3 million for transfers to a surviving spouse, only those very large estates with significant capital gains would be affected.

Strategy: Holding assets because of the potential to take advantage of a combined $4.3 million of stepped-up basis may still be beneficial to large estates. Selection of appreciated assets for charitable gifts becomes critical.

Scenario #6: The Decoupling Blues

A change affecting state death taxes could result from revenue-hungry states deciding to go after the estates of residents. Another possibility is some return to a Federal credit of some kind that is designed to restore parity in local death taxes and discourage interstate trafficking in estate assets.

Surprise Factor: There are 50 separate story lines developing so it is very easy for any estate to be caught off guard.

Strategy: Staying alert to local tax changes is critical. Changing domicile is possible but may have other unforeseen legal and tax consequences. Alternatives include transferring ownership of assets to partnerships and lifetime transfers in states that have no gift tax.

Scenario #7: The Leap of Faith

Why is it plausible to think that Congress will step in and change things once again to an approach we have not yet contemplated? Three big reasons:

1) You can't go home again. We've done the $1-million exemption thing. We've lived through the 55% top rate thing. Those rules are so yesterday.

2) Legislators will look ineffective if they can't avoid this worst-case reversion scenario.

3) Congress can't leave well enough alone even in the best of circumstances. A reversion to a set of rules that looks and feels regressive won't last five minutes.

Surprise Factor: A compromise of some kind may arrive in 2011 or much sooner. While the tax code of the United States will always remain as unpredictable as politics and culture itself, we must all deal with the ever present twin certainties of death and taxes.