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## The $2-Million Plateau

### The Right Time for the Bypass Disclaimer Trust?

***Also: New Rules and COLA Limits for 2006***

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We have now reached the high ground of the $2-million estate tax exemption.

Once upon a time, estate planners had grown complacent with a dependable $600,000 exemption level. Or, to be more accurate, a $192,800 unified credit that was the equivalent of an exemption of $600,000. That was once referred to as the "unified" credit because it reflected the coordinated estate and gift taxation system.

Although this history may seem increasingly less relevant, it is important to see where we came from to realize where we have arrived.

***Presented With Our Compliments***

We have been on a four-year expedition, making a steep climb upwards as the estate tax exemption reached $1 million, $1.5 million, and now, in 2006, a $2-million estate tax exemption that is supposed to stay in place for three years, long enough for estate planners to catch their breath.

Let's take a look around from this high plateau and see where we are headed next. We also summarize many of the other significant estate-planning rules and exemptions that have been modified by legislation or cost-of-living adjustments.

## *A Rapid Ascent*

Washington's first attempt to bring the estate tax exemption up to an appropriate level began cautiously with tax legislation in 1997 that increased the exemption by conservative increments for several years before large increases were to arrive. Under this plan, the estate tax exemption would not have reached $1 million until 2006.

Call that an exemption, only $1 million? That conservative approach may have helped inspire the next plan, i.e., the total repeal of the estate tax that was enacted in 2001. The complete repeal is to be phased in over many years, but the exemption amount quickly jumped to $1 million in 2002 and now, in 2006, the exemption stands at $2 million. This is exactly double what it would have been under the previously enacted tax approach.

Now that 2006 has arrived, the estate tax exemption has reached $2 million, where it will remain at $2 million for three years (barring additional legislation). Let's take advantage of this respite from unceasing change and set up a base camp at $2 million before making the final ascent toward total repeal.

## *Setting Up Base Camp*

What does the new exemption mean? Slightly lower taxes for a very small number of estates? The percentage of taxable estates had fallen below 1% in recent years and the $2-million exemption will undoubtedly send that number even lower.

But another highly significant aspect of the arrival of the $2-million exemption is, very simply, that it will remain the same for three years in a row (barring any other legislation before then).

In an estate-planning context of constant tax law revisions and total uncertainty, we are about to have a potentially stable three years.

Perhaps this is a good opportunity to take a deep breath and think about the type of planning that is needed with the $2-million estate tax exemption.

## *Strategic Responses*

For estates of $1.5 million or less, the higher estate tax exemption changes very little; small estates are already not taxable. Similarly, huge estates with many millions of dollars will face slightly lower taxes, but saving 46% tax on another $500,000 may not seem that critical in an estate of, for example, $25 million or $100 million, where adjustments to lifetime gifts and charitable contributions can offset changes of such significance.

But for estates in the $2.5 million to $10 million range, there are the most significant opportunities.

Married couples each have a $2-million exemption to utilize. Therefore, with basic planning, a total marital estate of $4 million can pass through the estates of husband and wife without triggering any estate tax. Equalization of each spouse's share of the estate may be important if each is to take full advantage of the $2-million exemption.

**Gifts of educational expenses**. To qualify for the unlimited exclusion for qualified education expenses, you must make a direct payment to the educational institution for tuition only. Books, supplies, and living expenses do not qualify. If you want to pay for books, supplies, and living expenses in addition to the unlimited education exclusion, you can make a gift of $12,000 to the student under the annual gift exclusion.

## *Disclaim At Will*

Or, more accurately, disclaim based on the will. By refusing to accept an interest created by a will or trust, a beneficiary causes that interest to be distributed to an alternate beneficiary. The disclaimant is treated as having predeceased the grantor or testator.

*Basics:* A disclaimer must be in writing, signed by the potential recipient of the interest to be disclaimed, and received by the transferor of the interest. Disclaimed assets must be specifically identified.[1]

Disclaimers must be made within nine months after the later of a) the date on which the transfer creating the interest is made, or b) the day on which

the transferee turns 21. A testamentary transfer generally takes place as of the date of death as opposed to when a will is probated.

## *Disclaimer Strategies*

In the following examples, testator T has made bequests to his surviving spouse S and beneficiary B:

**1.** T neglects to utilize a bypass trust and thereby fails to exhaust his unified credit. After T's death, S can disclaim a portion of the assets bequeathed to her. This removes assets from the protective umbrella of the marital deduction. T's unified credit is used instead of being wasted. The exercise of a disclaimer by S then can keep assets, and any appreciation on them, out of her estate. This avoids estate and inheritance tax as well as probate expense.

**2.** S or B can exercise disclaimers to shift income-bearing assets to a beneficiary who is in a lower income tax bracket.

**3.** Disclaimers can equalize estates to save taxes. For example, if T has named S as beneficiary of retirement accounts, insurance, or other assets passing outside of the will, the total of assets passing under the marital deduction at the death of the first spouse might be much larger than the amounts passing to other beneficiaries and to which T's applicable exclusion is being applied. If T dies in 2009 when the applicable exclusion is scheduled to rise to $3.5 million, much of T's exclusion could be wasted.[2]

**4.** If S were to die shortly after T, a disclaimer made by her executor could serve to reduce local tax and probate expenses.

**5.** B can disclaim assets so that they pass to S and qualify for the marital deduction. B may also want to increase the assets received by S based on her needs. Or, once the marital deduction is secured, S can distribute assets to B and B's children over time in amounts that qualify for the annual gift tax exclusion.

**6.** In the instance of a split-interest bequest to S and a charity that fails to qualify for marital or charitable deductions, a disclaimer by S could help salvage the estate tax charitable deduction.[3]

**7.** Where a charity is named as an alternate beneficiary, a disclaimer by the intended transferee enables the assets to pass from the estate to the charity and therefore qualify for the estate tax charitable deduction.

**8.** Disclaiming a power of appointment disposes of an interest that offers no current benefit yet will be included in the recipient's estate. A disclaimer of a power of appointment can enable property to qualify for the marital deduction as well as a QTIP election.

**9.** B's disclaimer may enable assets to reach other beneficiaries while avoiding tax liens and creditors (subject to local law).

**10.** If grandchildren of T are beneficiaries, their disclaimer could avoid the generation-skipping transfer tax. Assuming such assets flowed instead to B, gifts could be made using the annual gift tax exclusion.

## *Disclaimer Trusts*

In anticipation of disclaimers being used, a professionally administered trust can be established. Such a trust can provide alternate beneficiaries who would benefit in the event one of the beneficiaries of the will disclaims assets.

A trust can also provide guidance on how assets will be invested, supervised, and, ultimately, distributed. And if disclaimed assets are in a trust to begin with, they can remain in the trust—providing complete continuity of administration.

Naturally, the potential exposure of the assets to creditors of the surviving spouse's estate must be considered in making the decision to disclaim assets. Note that a fiduciary can be empowered to exercise certain disclaimers.

## *Conclusions*

As a practical matter, nine months following a death can pass very quickly. Planning a disclaimer ahead of time and empowering an executor, rather than a surviving family member, to exercise the disclaimer (as in a *Clayton* trust) can help an estate accomplish a disclaimer in timely fashion while remaining flexible.[4]

## TECHNICAL REFERENCES


1. IRC §2518(b) and Reg. §25.2518.
2. Dudley and Wallace, *A Client's Death Doesn't Mean All Planning Must Rest In Peace,* 17 Property & Probate 3, p. 42 (May/June, 2003).
3. *Rev. Rul. 89-31, I.R.B. 1989-9, 32;* and *Rev. Rul. 89-27, 1988-C.B.331.*
4. *Estate of Clayton v. Comm'r., U.S. Court of Appeals,* 5th Cir. (1992).


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## KEY TAX THRESHOLDS FOR 2006

**TOP ESTATE TAX RATE:** Drops to 46% (down from a top rate of 47% last year). It will drop again in 2007, i.e., to 45%, but that's the last drop for a while. The tax rate hovers at 45% in 2008 and 2009 and then drops to 0% in 2010

**GIFT TAX RATE:** Top rate also drops one percentage point to 46%, following the estate tax and the generation-skipping transfer tax.

**GIFT TAX ANNUAL EXEMPTION:** The gift tax annual exemption moved up $1,000 from $11,000 to $12,000 based on cumulative cost-of-living adjustments. If current inflation trends remain in place, the next jump, to $13,000, would arrive in three or four years.

**GIFT TAX LIFETIME EXEMPTION:** The lifetime exemption for gift taxation remained at $1 million, and will remain at that level through 2011.

**STATE DEATH TAX:** The state death tax credit had been phased out. State death taxes are treated as a deduction.

**SPECIAL-USE VALUATION:** The aggregate decrease in value of an estate using §2032A for estate tax purposes is limited to $900,000 in 2006 (up from $870,000 in 2005).

**NONCITIZEN SPOUSES:** The exemption under sections 2053 and 2523(I)(2) for gifts to noncitizen spouses increases from $117,000 to $120,000.

**CAPITAL GAINS:** Top rates of 15% and 5% continue to apply. Rates rise in 2009 but a low bracket of 0% will exist in 2008.

**ATTORNEY FEES:** Up to $160, an increase of $10. *Note: Revenue Procedure 2005-70,* containing a complete rundown of inflation adjustments, is posted on the IRS website.

## HALFWAY THROUGH ESTATE TAX PHASE OUT

### Estate Tax Evolution 2001 - 2011

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Income Tax Top Rate | 39.1% | 38.6% | 35% | 35% | 35% | 35% | 35% | 35% | 35% | 35% | 39.6 |
| Capital Gains | 20% and 10% | 20% and 10% | 15% and 5% (after 5/5/03) | 15% and 5% | 15% and 5% | 15% and 5% | 15% and 5% | 15% and 0% | 20% and 10% | 20% and 10% | 20% and 10% |
| Dividends | Ordinary income | Ordinary income | 15% and 5% | 15% and 5% | 15% and 5% | 15% and 5% | 15% and 5% | 15% and 5% | Ordinary income | Ordinary income | Ordinary income |
| Gift Tax Top Rate | 55%+ | 50% | 49% | 48% | 47% | 46% | 45% | 45% | 45% | 35% | 35% |
| Gift Tax Exemption | $675,000 | $1 million | $1 million | $1 million | $1 million | $1 million | $1 million | $1 million | $1 million | $1 million | $1 million |
| Estate Tax Top Rate | 55%+ | 50% | 49% | 48% | 47% | 46% | 45% | 45% | 45% | 0% | 55%+* |
| Estate Tax Exemption | $675,000 | $1 million | $1 million | $1.5 million | $1.5 million | $2 million | $2 million | $2 million | $3.5 million | n/a | $1 million* |
| Basis at Death | Stepped-up basis | Stepped-up basis | Stepped-up basis | Stepped-up basis | Stepped-up basis | Stepped-up basis | Stepped-up basis | Stepped-up basis | Stepped-up basis | Carry over basis** | Stepped-up basis* |

+ = In addition to the 55% rate, a 5% surtax applied to certain estates exceeding $10 million.

* = In 2011, item reverts to 2001 level unless Congress enacts further legislation.

** For carryover basis in 2010 (and beyond if extended by Congress), a limited stepped-up basis would continue to apply to the first $1.3 million of capital gains transferred to a nonspouse and the first $3 million of capital gains transferred to a spouse.