The dangers of postponing estate planning until Congress clarifies the law

The basic structure of taxing estates has not changed since 2001. The Economic Growth and Tax Relief Reconciliation Act of 2001 put into the law the gradual increase in exemption amounts and decrease in marginal rates that we are still working with today. It also put in place the elimination of the estate tax in 2010 and its return in pre-2001 form in 2011 that has made estate planning during this decade so difficult.

The response of a lot of taxpayers appears to be to wait until the law settles to revise their estate plan. This strategy has been, and continues to be, ill advised for a number of reasons. Some issues particularly unique to 2009 have made taking action sooner rather than later even more important.

In 2009, the estate tax exemption amount jumped from $2 million to $3.5 million. This change could overfund family trusts and underfund marital trusts in estate planning documents that did not anticipate such increases in the exemption amounts. Although it appears likely Congress will act in the near future to address the estate tax at least for 2010, waiting to see what Congress does leaves many taxpayers exposed to inadequate estate plans right now.

In 2009, we are also in a period of historically low interest rates and property valuations. Many estate planning techniques can utilize these to much more effectively lower the value of taxable estates. They only work so effectively, however, if they are put in place while the low interest rates and low property valuations still prevail in the market. We are likely to have already bottomed out on both and both are expected to rise. Delay means that these estate planning techniques may be somewhat less effective in the future than they could have been.

For these reasons, estate planners should encourage their clients to address their estate plan issues now, rather than waiting for Congress to settle on the law going forward.

The current push in Congress seems to be to prevent both the repeal in 2010 from occurring and also the return to the pre-2001 estate tax from occurring. The Obama administration has proposed making the current 2009 exemption and tax rates permanent. Such a change would give us a $3.5 million exemption amounts going forward and a top estate tax rate of 45 percent. It seems most likely at this point that Congress will extend these 2009 levels for only one year. Such a step would prevent estate tax repeal and would also be a revenue-raiser that might pay for something else that Congress would like to do. Extending the 2009 levels into 2011 would start to cost revenue and therefore might be postponed.

There is also discussion of making the exemption amount transferable to a spouse, so that one would not have to create a family trust to ensure that the estate tax exemption of the first to die is fully utilized. Whatever is not utilized by the first to doe could be utilized by the second.

There is also discussion of a reunification of the gift and estate tax. Currently the lifetime gift tax exemption is only $1 million. Reunification could mean that the lifetime gift tax exemption would also rise to $3.5 million. This possibility would indicate that taxable gifts should be avoided in the current environment. However, if estate planning is avoided until the law is clarified, opportunities for estate tax avoidance or making sure that the testator's wishes are fulfilled under the current estate plan could be lost.

If an estate plan funds the family trust with property equal to the exemption amount and funds the marital trust with the balance, as exemption amounts have gone up the surviving spouse could be left in a position of not having sufficient funds to live on for the remainder of their life, and could be dependent on the children for support. An estate of $3 million would have only funded the family trust with $675,000 if the death had occurred in 2009. The remaining $2,325,000 would have gone to the marital trust. If the death occurs in 2009, however, all $3 million goes to the family trust and the marital trust gets nothing. This is not likely to be what the testator intended.

Estate plans that are not flexible enough to accommodate these increased exemption amounts and leave the estate plan vulnerable to not fulfilling the testator's wishes, and delaying modification until the tax law is clarified merely extends the period of risk.

If there is a silver lining in the economic recession, it is that the historically low interest rates and property valuations provide great estate planning opportunities. These opportunities exist only so long as those interest rates and valuations remain low. Common estate planning techniques such as grantor retained annuity trusts and qualified principal residence trusts work even better in a low interest/low valuation environment. The current environment even makes possible low-interest loans to family members without imputed interest issues.

Estate tax freezes utilizing such techniques as installment sales, self-canceling installment notes, intentionally defective grantor trusts, and family limited partnerships also work particularly well when interest rates or property values are low. If one waits until the estate tax law is clarified, not only is there a risk that valuations and interest rates will rise by that point, but also there is a risk that Congress will also take measures to curtail the advantages of some of these techniques. For example, Congress has discussed limiting the valuation discounts available through the use of family limited partnerships.

Low valuations also can be significant in determining when to make Roth IRA conversions or recharacterizing conversions made within the prior year when valuations ere higher. Many wealthier taxpayers will not be able to do Roth conversions until 2010, when the income restrictions go away. Low valuations may persist into the new year, but if we are in the midst of a recovery, making those conversions early in the year may be more beneficial than waiting until later in 2010. Although Roth conversions in 2010 qualify for an election to tax the conversions in 2011 and 2012, taxpayers will also need to help with the decision of whether the possibility of higher marginal tax rates in 2011 and 2012 warrants passing up the deferral and just paying the tax on conversion in 2010.

The lower property valuations can also impact the choice of the alternative valuation date, six months after the date of death, for active estates. Recent proposed regulations indicate that the alternative valuation date may be chosen when valuations are lowered due to market forces, but not when properties are manipulated to artificially lower market valuations.

SUMMARY

Although in a down economy the last thing that many taxpayers may want to hear is that they should spend money now to revise their estate plans, estate planners would be better off advising their clients of the merits of doing estate planning now, rather then waiting until Congress clarifies the law.

It would be better to be told "No" by the client than for the client to ask after the fact why the opportunities afforded by low interest rates and low property valuations were not made know to them. Or, even worse, to explain to surviving spouse why they need to ask for support from the children because the marital trust was inadequate to provide the support that the other spouse had intended.

Discussions with clients should probably focus at this point on the assumption that Congress will extend the 2009 exemption levels and estate tax rates through at least 2010, but waiting until Congress actually acts to do current estate planning may expose many clients to considerable risks, and result in the client missing one-time planning opportunities afforded by low interest rates and low property valuations, of which they should be made aware.