What Could Be More Cert

What could be more certain than death and taxes? The answer is "change." Based on various surveys, most Americans perceive the federal estate tax to be unfair. Ironically, it only affects less than one percent of our population per year, and accounts for less than one percent of annual federal tax revenues. According to the IRS there were only 91,679 Estate Tax Returns filed in 2003, of which only 2,491 were filed for Michigan residents. It is alleged that it costs the federal government as much as $.65 to collect $1.00. In reaction to curbing the impact of the federal estate tax, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and consequently, through this change, created an atmosphere of instability and uncertainty in many facets of estate planning.

The Answer Is Change

By Henry P. Lee

EGTRRA temporarily repealed federal estate and generation-skipping transfer (GST) taxes for the year 2010 only, phased down the estate tax rates through 2009, continued the federal gift tax with a cumulative limit of $1 million in gifts before the imposition of gift tax liability, modified the carryover basis rules (i.e., whether or not the cost basis of a decedent's assets would be stepped up to date of death values), and phased out the state death tax credit through year 2004.

One of the reasons for the lengthy phase-out of federal estate taxes in EGTRRA was to comply with the "Byrd Rule" in which it would be out of order for the U.S. Senate in the absence of 60 votes to include in matters of budget reconciliation increases or deficits beyond the fiscal years covered by the budget reconciliation (i.e., beyond a ten-year budget window).

In reality, this alleged repeal is not really a repeal because EGTRRA's provisions shall not apply to estates of decedents dying, gifts made, or generation-skipping transfers made after December 31, 2010. Consequently, without further congressional action, the laws will

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"sunset" back to the law that was supposed to be in effect pursuant to the Taxpayer Relief Act of 1997, in which there was a unified estate and gift tax credit equivalent to a $1 million exemption, a top tax rate of 55 percent, and in some cases a 5 percent bubble, for a total of 60 percent, a Qualified Family Owned Business Interest (QFOBI) deduction, an indexed Generation-Skipping Tax Exemption (GST), a full state death tax credit, and a full fair market value basis step up in assets at death.

Unfortunately, Congress, possibly in a further legislative effort to utilize the Byrd Rule, could extend the one-year "repeal" to year 2015 or later as another possibility, thus prolonging the uncertainty. These EGTRRA changes have resulted in significant confusion for estate planners because of the sunsetting possibilities and, even worse, misimpressions by our clients, who no longer believe that they need to do estate planning, since they are under the perception that the "Estate Tax has been repealed."

What Does all of This Mean to the Legal Profession?

Therefore, the balance of this article will deal with these issues and what to do in this climate of uncertainty. You will need to reflect on how these issues impact your client base and whether, in your opinion, you should take any action with regard to possible follow-up. The ethical dilemma, which is not within the scope of this article, is whether you have informed your clients that your prior activities are closed and therefore whether you have an obligation to pursue "former" clients. Provided, however, if you continue to have an ongoing relationship as to any matters with a particular client, or if you were named as a fiduciary in that client's will and/or trust, then it is probably incumbent upon you as the client's attorney to inform the client of the changes in the law (present and future) and the need to follow up on possible revisions to their planning and related documentation. It is permissible nevertheless to periodically communicate with "former" clients as to reactivating the estate planning process. The other dilemma is whether you could successfully get your clients to respond to these issues, which should not negate any follow-up efforts on your part.

Suggested Strategies in This Climate of Uncertainty and Drafting Considerations

The statutory instability posed by EGTRRA has placed estate planners in a position to re-evaluate approaches to planning and drafting. The following topics include possibilities that are not intended to be exhaustive but may merit attention:

The Rising Applicable Exclusion

Allocating the first dollars to a bypass trust may produce unintended results. The Applicable Exclusion (really the federal estate tax exemption on the first $1.5 million in assets) is scheduled to rise in stages to a tax exemption for the first $3.5 million in 2009 (the Applicable Exclusion), before reverting back to a tax exemption on the first $1 million in assets in 2011. Therefore, if a trust provides that the assets are first allocated to a bypass trust, the surviving spouse might be placed in what could be perceived to be an unwanted restrictive position. There may be an objective to create additional flexibility for the surviving spouse via first allocating the primary assets to Marital Share, either outright or in trust, which if partially or totally disclaimed, would pass to a bypass trust per the terms of the governing instrument.

Generation-Skipping Transfer Tax (GST)

The Generation-Skipping Transfer Tax (GST) exemption will rise and match the increase in the Applicable Exclusion. Documents that have previously carved out, by formula, an allocation for the benefit of grandchildren to the extent of the maximum GST exemption also could produce unintended results that could result in an almost virtual disinheritance of the children. Consequently, documentation should possibly be amended with a cap below the GST exemption limits, which could rise to as high as $3.5 million per grantor by 2009, or should possibly be eliminated in their entirety. Remember, bequests to grandchildren are still subject to the federal estate tax and any excess above the GST exemption would trigger an additional GST tax. Beware: The Treasury Department has issued proposed Regulations that have created additional confusion regarding GST planning.

Need for Flexibility—Provide for Trust Protector

How to draft documents for the one-year repeal of the federal estate tax and generation skipping transfer tax for the year 2010, and future changes in the law, is quite problematic because language and formulas in existing trusts with regard to these concepts would become illogical when there is no need to make adjustments to accommodate non-existing federal estate taxes. This is the old "catch 22" situation. Therefore, build into your documents as much flexibility as possible, which, if the grantor could not act, likely could include an independent Trust Protector, who is a person, committee, or entity selected by the Trustee with the power to amend or terminate the trust if compliance requirements have changed or if the document no longer serves its intended purposes.

Verifying Ownership and Funding of the Trust

Verifying ownership and trust funding is more important than ever. The obvious advantage could be that, with two separate smaller estates between a husband and a wife, no federal estate tax would be due at either death because of the rising Applicable Exclusion. With the increase in the Estate Tax Applicable Exclusion, married couples may need to revisit shifting more assets to the spouse with a smaller estate. Memorialize your advice to your client accordingly with correspondence, and document any lack of information, lack of cooperation, or lack of follow-through by the client. Review income tax returns, deeds, and brokerage statements as a means of determining the presence of assets and who may own them. Often, the client has inaccurate recollections about these details.

Gifting, Sales, and Inter-Family Loans

Encourage gifting and tax-preferenced sales techniques and inter-family loans because the interest rates prescribed by Applicable Federal Rates (AFR) are still low. Renew inter-family promissory notes at the low AFR interest rates for terms not more than three years at 2.26 percent, for terms up to nine years at 3.62 percent, and for terms of more than nine years at 4.84 percent, based on October 2004 AFR rates. For Grantor Retained Annuity Trusts (GRATs), Qualified Personal Residence Trusts (QPRTs), and Charitable Remainder Trusts (CRTs), the October 2004 Section 7520 rate of 4.4 percent would instead be applicable. Gifting techniques could include, but are not limited to, the use of Family LLCs, GRATs, QPRTs, CRTs, and Irrevocable Life Insurance Trusts (ILITs), and sale techniques could include, but are not limited to, Intentionally Defective Grantor Trusts (IDGTs) and possible use of Self-Canceling Installment Notes (SCINs). These various techniques could be possibly coordinated with each other.

Reflecting the Client's Intent

Take detailed notes that reflect the intent of your client. Jennifer R. Bailey wrote an excellent article, "Professional Liability Issues Specific to the Estate Planning Attorney,"[1] and my remarks attempt to paraphrase her comments. In malpractice cases, she claims that the general rule is that an attorney may be held liable only to his or her client for his or her negligent acts. However, in order for a third-party beneficiary to have the right to sue, the beneficiary must be named in the dispositive document and present evidence, which must be found within the four corners of the instrument that the "true intent" of the testator was frustrated. However, per Michigan case law, documents that are "part and parcel" of an estate plan could possibly give rise to a third-party beneficiary's standing to litigate and could be used to determine the intent of the testator.

Consequently, the attorney should take detailed notes reflecting the intent of the client, noting the impact on beneficiaries including those who could be adversely affected. These matters should be summarized in engagement agreements, or in a confirmation letter, or in an outline of the documents, with the client preferably having time to digest these issues prior to scheduling a document execution date. The attorney should consider a summary letter reaffirming these issues in laymen's terms; the client should date and initial the summary letter or the plan summary and even selective sections of the actual documents to evidence that these documents were explained to the client, and therefore the client understood his or her own actions, and that the actual documentation reflects the true intent of the client.

The New Michigan Uniform Principal and Income Act

The new Michigan Uniform Principal and Income Act (UPIA) became effective September 1, 2004, and applies to estates and trusts of decedents except as expressly provided to the contrary in the terms of the decedent's will or trust. Section 104 of the new Michigan UPIA grants a trustee, under certain circumstances, the power to adjust (equitable adjustments) and recharacterize income as principal or principal as income if the trustee determines that such an adjustment is necessary in order to treat beneficiaries impartially. In our current low-dividend-yield market, a trustee might recharacterize capital gains as "income" and thereby have more to pay out to the current beneficiary. In the absence of specific direction in the document or authority granted to the fiduciary, UPIA stipulates what constitutes principal or income for trust accounting purposes that does not necessarily track with typical impressions of what is either principal or income.

As a prerequisite to these equitable adjustments, the trustee must comply with the Michigan Prudent Investment Rule, which became effective on April 1, 2000. This rule, in concert with the Modern Portfolio Theory of Investment, emphasizes the entire portfolio with an overall investment strategy with evaluation of individual assets only in the context of the whole, and de-emphasizes dividends, interest, and rents. The Michigan Prudent Investment Rule (EPIC § 1502(2)) is a default rule that could be expanded, restricted, eliminated, or otherwise altered per the terms of the governing instrument. Therefore, for guidance to the fiduciaries as to the scope of these issues, we should consider the following in our drafting:

- Specify, in writing, preferences for one beneficiary over other beneficiaries, even to the point of exhausting the principal for the benefit of the favored beneficiary; even provide for principal distributions without regard to the favored beneficiary's personal financial resources.
- Consider various distribution formats including unitrust formulas such as three to five percent of principal, regardless of the actual income; this is probably not wise in Marital Deduction situations where all of the net income should be

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distributed to the surviving spouse periodically, but no less frequently than annually. However, the instrument could provide to the spouse the greater of the two.

- Give the fiduciary the authority to determine the allocation of any distribution as to what constitutes principal or income.
- Consider changing or removing the Prudent Investor Rule, which would preclude the power to adjust in the event of a full elimination of this rule.
- The UPIA provides that 90 percent of required minimum distributions from IRAs and qualified plans are to be allocated to principal and 10 percent to income. If the distribution were not a required distribution, then 100 percent would be allocated to principal. A different distribution allocation could be made by the fiduciary, which authority should be specified in the governing instrument. It is essential to discuss these distribution alternatives with the client.
- Per the UPIA, there are different classifications as to what constitutes income versus principal for distributions from partnerships, corporations, and regarding short-term capital gains from mutual funds that also merit similar analysis and discussion.

De-coupling the Michigan "Estate Tax" Act from the Federal Estate Tax Rules

This issue is not real as of this date in Michigan, but could become so in the spring of 2005 if the Michigan economy does not improve and Michigan continues to have budget deficits. Therefore, it must be addressed. Per Section 2011 of the Internal Revenue Code, EGTRRA phased out the state death tax credit over four years ending with year 2004. Therefore, beginning in 2005, there will no longer be a state death tax credit, but state death taxes (if any) will be deductible in determining the federal estate tax. Michigan consequently will no longer receive a "piece" of the federal estate tax equivalent to the federal state death tax credit, resulting in lost potential revenues in excess of $100 million annually. The pre-EGTRRA state death tax credit returns in 2011.

Seventeen other states and the District of Columbia have passed de-coupling statutes as of June 2004, which are not consistent with each other as to their approaches to de-coupling. Some have de-coupled the amount that is exempt and others have de-coupled the tax rate. These techniques produce very different results. It is not clear whether or when de-coupling will take place in Michigan because an effort to do so was defeated this year per House Bill 5708 by a vote of 33 to 70. If de-coupling became a reality, we would need to change our planning strategies, which could include advising clients to do more aggressive gifting as well as possibly dictating the need to revise their estate planning documents.

Eldercare

Providing for disabled and elderly family members; it is alleged that the fastest-growing segment of our population consists of people over the age of 100 years.

Documentation Review and Reformation

This would include verification that documentation complies with EPIC (the Estates and Protected Individuals Code) as well as EGTRRA; review of tax apportionment clauses; finding bad cross-references; verifying proper incorporations by reference; detection of ambiguities; discovery of blank spaces not being filled in; ascertaining that documents properly coordinate and integrate with each other; double-checking for redundant provisions because, for example, there may be an intent of the grantor to have various sub-trusts that are slightly different; uncovering vagueness; and confirming compliance with other Michigan and federal tax laws. This document review process may result in your conclusion for the need for formal reformation of irrevocable trusts, including old life insurance trusts and trusts of decedents, as well as certain charitable trusts.

Asset Protection

Asset protection and how it could correlate or contradict good estate planning, all subject to the appropriate ethical considerations.

Marital Agreements

Marital agreements for both first and second marriages, including ante-nuptial and post-nuptial agreements, as well as possible irrevocable inter vivos QTIP trusts. This may require additional planning in order to protect the needs of children of the first marriages, including changes in how assets are held, as well as making sure that the estate planning coordinates with judgments of divorce.

Updating Powers

Updating and revising health care and general durable powers of attorney, including covering HIPAA issues. In many instances, these documents need constant revision because they can become old and stale and unwelcomed by third parties. For example, special language now needs to be incorporated in writing to provide authority for third parties to make anatomical gifts only if the client were unable to act on his or her own behalf. Trustees of revocable trusts have no authority to act on behalf of qualified plans and IRAs because they are not the "legal" owners of these plans and IRAs. This is within the jurisdiction of an agent under a general durable power of attorney and accordingly should be specified in the powers.

Step-up in Basis

Currently, one receives a step-up in basis for income tax purposes to the date of death values. If a client acquired a share of stock for $10 during his or her lifetime and it were worth $100 at his or her death, the new cost basis would be $100 and no income tax would be due on the first $90 of appreciation at the time of disposition after death. EGTRRA provides that, in year 2010, the total amount of assets eligible for this step-up in basis is $1.3 million for non-surviving spouses and an additional $3 million for surviving spouses. Consequently, we may be creating separate trusts for assets subject to the step-up and those not eligible for the step-up.

Perpetuating IRAs in Trust

The Federal Treasury Department issued final revisions to Internal Revenue Code § 401(a)(9), regulations dealing with Required Distributions from profit-sharing pensions, IRAs, 401(k)s, 403(b)s, etc. This has additional and substantial estate planning significance. For example, Grandpa could leave his $100,000 IRA in a separate "IRA Trust" for his 19-year-old granddaughter who, with an overall 8 percent yield, would receive $5 million in distributions over her lifetime, which represents a 50-fold increase. Therefore, we may be drafting IRA Trusts and would need to deal with the respective tax apportionment in Wills to provide that the taxes are first to be paid from the estate and hopefully not from the IRA. It is prudent to have the IRA distributions pass through a dedicated trust, which complies with ERISA requirements, and not through the client's revocable living trust. IRA trusts are created for many reasons, including the funding of bypass trusts to the extent that the other estate assets are insufficient for this purpose, to assure investment control by the trustee, to prevent the beneficiary from withdrawing more than the minimum required distributions unless more were needed in the trustee's discretion, to keep the funds in the family blood line, and to provide a retirement annuity for the next generation. In addition, it is important to verify that the planning for your clients' retirement accounts is consistent with their other estate planning. For example, it is not uncommon for the client to set certain ages with defined payout periods in the revocable living trust as to when the children will have access to the funds, but at the same time, in the absence of an IRA trust, name the children as the outright beneficiary of an IRA. These two planning concepts are contradictory and bode for reconciliation.

Income and Charitable Planning

Greater evaluation of income tax planning opportunities, including possible charitable considerations. With lower or no estate taxes, there may be more availability of funds for charity.

Probate Process

Planning to utilize or minimize the probate process.

Disclaimers

Consider the opportunity for disclaimer planning in which a beneficiary could "renounce" his or her right to part or all of certain assets upon the death of a grantor, which assets would then pass to the next designated persons prescribed in the grantor's documentation as though the disclaiming party had predeceased the grantor, or as prescribed by Michigan law in the absence of such documentation. If done within nine months of death, under most circumstances this will not trigger any gift tax consequences.

Estate Planning v Estate Tax Planning

In this world of uncertainty, one thing is often constant: your client's need for control. Therefore, regardless of whether there is an Estate Tax in place or not, your client may often want to control when and how and which family members have access to the assets, regardless of the size of the estate. As increased exemptions from estate taxes may or may not be made permanent, our clients likely will continue to focus more on disposition planning (i.e., estate planning).

Business and Investment Planning

The client may possess an interest in a business or an investment for which it should be determined how and whether to perpetuate it. This could include a need to review and/or implement, buy/sell, or shareholder, partnership or operating agreements to conclude if they are consistent with the client's goals, planning objectives, and needs.

Reconciling Assets Held in Other States

Some clients may own real estate, for example, a second home in South Hampton, New York or a cottage in Ohio. You should consider funding these kinds of properties in a Michigan Revocable Living Trust, hopefully to bypass the probate process in other states for purposes of expediency. Nevertheless, this will not eliminate likely death taxes in places where there is a separate state tax of some form. Certain commentators believe that conveying real estate into a limited liability company will convert the realty into personalty and therefore eliminate this issue; this approach may be extremely aggressive and easily challengeable.

The "Reverse" Estate Tax

Perhaps tongue in cheek, on April 1, 2004, Steve Leimberg's Estate Planning E-Mail Newsletter—Archive Message #658 in its Executive Summary described a "reverse estate tax" as follows:

> *"The Bush administration late yesterday—shortly after the markets closed—advanced a major proposal to permanently eliminate the federal estate tax and replace it with what officials call a reverse estate tax. Under the (we anticipate) controversial proposal, the heirs of a deceased individual would owe no tax to the government, regardless of the size of the decedent's estate.*
>
> *Instead, the estate will be entitled to receive from the US Treasury a direct deposit cash payment exactly nine months after the date of an estate owner's death (probably subject to a six month alternate valuation date—although this was not clear from the wording of the bill or the Treasury's bulletin).*
>
> *Although details have not yet been finalized, the amount of the payment will depend on the size of the estate, with the largest 1 percent of all estates receiving the most substantial subsidies. A special bonus would be paid to families of members of Congress and wealthy farmers who have never driven tractors."*

In conclusion, possible changes in the case law, rulings, and legislation should not diminish the need for estate planning. The most difficult aspect emanating from these changes would be how to deal with misconceptions or perceptions of our clients who might believe that our services could be eliminated or deferred because tax-motivated planning would no longer be necessary. Clients do not like to acknowledge the possibility of death and would like to rationalize that planning for this event would no longer be necessary. However, questions regarding tax planning will not resolve issues prompted by changes in the client's feelings, asset picture, health, and family status. Therefore, we must continue educating our clients that the need for estate planning, i.e., who is to get what, where, when, and how, will never end, regardless of whether or not planning or decisions were tax motivated. In the absence of this planning, the state of Michigan has a plan via intestacy, which easily may not be what the client wants. ✦

Henry P. Lee is a member with his son, Andrew R. Lee, of The Lee Law Group, PLLC. He graduated from the University of Michigan, B.A., Indiana University, J.D., and New York University, LL.M in Taxation. He is past-chair of the Oakland County Bar Association Tax Committee. He has chaired the Estates and Trusts Committee and the 2004 Summer Tax Conference of the Taxation Section of the State Bar and is a member of its Tax Council. He has served on the faculty of the American Bar Association/American Law Institute and is an ICLE presenter.

Footnote

1. *Michigan Probate and Estate Planning Journal,* Volume 23, Spring 2004, No. 2, pp 29–30.