

## TOP 10 MISTAKES BY ESTATE PLANNERS

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### INTRODUCTION

Estate planners can make many different types of mistakes, from leaving an important clause out of a will to miscalculating the projected estate tax. This presentation will focus primarily on mistakes arising out of common misunderstanding and misapprehensions about the use and effect of estate planning (including post-mortem estate planning) techniques and opportunities.

#### Estate Planning Mistake #10

##### Misunderstanding the Issue of Where to Deduct Estate Administration Expenses

Most estate planners are aware that under IRC § 642(g), estate administration expenses may be taken as estate tax deductions or income tax deductions, but not both. In most taxable estates, i.e., estates where a federal estate tax is payable because there is no unlimited marital deduction and the estate is large enough (when combined with adjusted taxable gifts) to exceed the applicable exclusion amount, it has traditionally made sense to take administration expenses as estate tax deductions, because the marginal estate tax rate has usually been higher than beneficiaries' marginal income tax rates. However, it is important to do an analysis in each case to determine which is more advantageous for the client. In making this analysis, keep in mind the time value of money, because all estate tax deductions generate a benefit as of nine months after date of death, whereas an expense paid in the third or fourth year of estate administration will not generate a benefit until the filing of the fiduciary income tax return for that year.

The situation is different where there is a surviving spouse and a marital/credit shelter formula structure in the will designed to fund a credit shelter trust with the maximum amount that will not generate a net estate tax. In this case it appears at first blush that, since the estate tax is zero because of the formula, there is no value in taking expenses as estate tax deductions. Accordingly, some planners will automatically take the expenses as income tax deductions on the 1041.

This analysis is faulty and will in most cases result in a larger marital disposition and a smaller amount going into the credit shelter trust, thus potentially generating more estate tax upon the surviving spouse's later death. To illustrate, imagine a \$10,000,000 marital estate with \$500,000 in administration expenses, where the "target" taxable estate is \$1,000,000 (the applicable exclusion amount). If the expenses are taken as estate tax deductions, then there will be a marital deduction of \$8,500,000 and a § 2053 deduction of \$500,000, leaving a taxable estate of \$1,000,000, which passes to the credit shelter trust. If, however, the expenses are taken as income tax deductions, then it is necessary to increase the marital disposition to \$9,000,000 to result in a taxable estate of \$1,000,000. The \$500,000 of expenses are in effect the same as a nondeductible bequest, and effectively reduce the credit shelter bequest to \$500,000.

This is not to suggest that it is necessarily wrong to take the expenses as income tax deductions in this situation; the point is that the value of the income tax deduction must be weighed against the future value of sheltering funds from taxation in the surviving spouse's estate.

The above discussion has assumed that all the administration expenses are "transmission expenses," as described in Treas. Reg. § 20.2056(b)-4(d), rather than management expenses. Typically, most estate administration expenses are transmission expenses, including most legal fees, executor and personal representative commissions, appraisal fees and litigation costs. However, in most cases to the extent that the estate has management expenses, such as investment management and custody fees, those expenses can be taken as income tax deductions without increasing the marital disposition and decreasing the credit shelter trust.

In summary, there are not universal rules as to where administration expenses should be deducted, and it would be a mistake to make that determination without analyzing all the relevant factors.

#### Estate Planning Mistake #9

#### Not Factoring into an Estate Plan the State Death Tax Credit

With the recent "decoupling" of many states from the "pickup tax" regimes that were almost universal a few years ago, it has become even more important to be aware of the impact of the credit on a client's estate plan.

First of all, all estate planners should be sure that the formula credit shelter clauses in their wills and revocable trusts properly refer to the impact of the state death tax credit so that they will not inadvertently increase the total tax payable by the estate.

It is important to bear in mind that the state death tax credit is computed as a percentage of the taxable estate only, and not adjusted taxable gifts, even though the estate tax is computed on the sum of the taxable estate and adjusted taxable gifts. In some states, such as New York, the

state estate tax is equal to the amount that the state death tax credit would have been in the absence of the phase-out enacted in EGTRRA of 2001. In such states, if there is no state gift tax, a high net worth unmarried client on his death should consider giving away a substantial portion of his estate to his beneficiaries prior to his death. This will not significantly change the overall federal tax liability; however, the state estate tax will be substantially reduced or eliminated because the client has changed from having a large taxable estate to having large adjusted taxable gifts.

Lastly, planners should bear in mind that, in computing the § 691(c) income tax deduction for estate taxes paid on income in respect of a decedent, only the federal tax net of the state death tax credit qualifies. Thus, where a terminally ill client has a choice of whether to recognize income before or after death, it may be preferable to recognize it prior to death.

### Estate Planning Mistake #8

#### Creating a Credit Shelter Plan that Doesn't Work Because of Non-Probate Property

A practitioner can prepare wills (or revocable trusts) that appear to utilize each spouse's unified credit efficiently, but if each spouse does not have sufficient assets passing under the instrument to fully fund the credit shelter trust, the first spouse's unified credit may be wasted.

For example, if the bulk of a couple's assets are in the sole name of Spouse A, but Spouse B dies first, the best will in the world will not prevent spouse B's unified credit from being wasted. This problem can be avoided in most cases by analyzing the couple's holdings and advising them of the importance of having sufficient assets in each spouse's name. If Spouse A is comfortable transferring assets into Spouse B's sole name, or retitling assets so that they are held as tenants in common, the problem is easily resolved. If Spouse A is reluctant to make such a transfer outright, a transfer into a lifetime QTIP trust is worth considering.

The problem also arises where the first spouse to die holds assets in joint name or in a form that passes by beneficiary designation, such as retirement benefits or life insurance. If the property is held jointly with the other spouse, with right of survivorship, they should consider retitling the property as a tenancy in common. If this is not done, it is possible that the surviving spouse can disclaim his or her interest passing by survivorship from the first spouse to die, which causes that interest to pass through the decedent's probate estate. After many years of opposing the disclaimer of joint property, the IRS eventually conceded the point and issued regulations governing the matter under § 2518.

As to retirement plan assets or life insurance payable to the surviving spouse, it is possible to change the beneficiary to the decedent's estate (or, on post-mortem basis, disclaim so that the estate becomes the beneficiary), but this has potential negative consequences. In the case of life insurance, it would take an asset which is probably protected by state law from the claims of the decedent's creditors, and expose it to such creditor's by making it payable to the estate. It

would also subject the insurance proceeds to probate-related costs, such as executor's commissions or legal fees, in some states. As to retirement benefits, such as IRA's or 401(k)'s, making the estate the beneficiary would have all the same negatives as with life insurance, but in addition would in most cases take away the ability to continue to defer income tax realization through a spousal rollover.

In summary, it may be difficult to structure the clients' assets so as to fully utilize the credit shelter structure, but it is the estate planner's duty to advise the clients on their options.

#### Estate Planning Mistake #7

##### Routinely Making Cash Bequests to Individuals or Charities at the First Spouse's Death

It is certainly common for each spouse to provide for modest bequests to be made upon his or her death, even if the other spouse survives. There is nothing inherently wrong with such bequests, but the clients should be advised that there may be more tax efficient ways of making the gifts.

If the client wishes to make bequests to individuals, such as collateral family members or friends, he should be aware that this will result in a smaller credit shelter trust, and thus more potential estate tax at the second spouse's death. If the client is comfortable with the idea, he can instead bequeath such sums to his spouse, with the non-binding expectation that she will use her annual exclusion to make gifts during her lifetime to such individuals, and thus maximize the first spouse's credit shelter trust for the ultimate benefit of the couple's children. As a backup, the surviving spouse's will can provide for bequests to those individuals if she for any reason (such as death shortly after the first spouse) fails to make the annual exclusion gifts. If the first spouse's will sets up a QTIP trust for the survivor, it is easy to provide for payments out of the QTIP trust at the survivor's death as a backup if the surviving spouse does not make the gifts.

In the case of charitable bequests, whether modest or sizeable, it is similarly desirable to have the gift made by the surviving spouse during her lifetime rather than from the estate of the first spouse. In this case, however, it is not because of an estate or gift tax benefit, but because the surviving spouse will also be entitled to an income tax deduction.

Once again, it is not the estate planner's job to "tell" the clients what they should do, but it is his or her job to fully advise the clients on their options, and what the tax consequences are.

#### Estate Planning Mistake #6

##### Ignoring the Income Tax Basis Consequences of Lifetime Gifts

Although pursuant to EGTRRA we may have carryover basis beginning in 2010, for now and the immediate future assets included in a client's gross estate receive a new basis equal to

their estate tax value, pursuant to § 1014. On the other hand, property that is transferred by lifetime gift keeps the door's basis in the hands of the donee, subject to certain adjustments, pursuant to § 1015. Because in most cases an estate and gift tax saving from a lifetime gift will outweigh the loss of a basis step-up at death (in the case of appreciated property), the income tax issue is not always fully discussed with the client.

When an estate planning motivated gift is being contemplated (particularly by an elderly client or a client in poor health), any unrealized gain on the property to be gifted should be taken into account. All else being equal (which is rarely the case), it would be better to make gifts of assets without substantial unrealized gain at the time of the gift. Note that if the gift is to a grantor trust, the client may be able to later purchase (for fair market value) appreciated assets from the trust pursuant to Revenue Ruling 85-13, thus bringing the appreciated assets back into his estate for basis step-up purposes.

It is particularly important to analyze the income tax consequences in the case of a qualified personal residence trust. Although the estate and gift tax savings from a QPRT can be dramatic, they should always be analyzed against the potential capital gains tax to the remaindermen, especially where the home has a substantial unrealized gain at the time the QPRT is established, and it is likely that the remaindermen will sell the home shortly after the clients' death (after the end of the QPRT term).

As estate tax rates decrease, it may frequently be a closer call as to whether a lifetime gift makes sense, and the estate planner must make sure that the clients are aware of the trade-off.

#### Estate Planning Mistake #5

#### Assuming That, Because a Client Has Not Used His Unified Credit, He Can Make a Gift of the Applicable Exclusion Amount Without Incurring a Gift Tax

This nasty trap has two variations. In the first scenario, a client wishes to make the largest gift possible without paying tax. The estate planner ascertains that the client has never used any unified credit, and advises her that she can make a gift of \$1,000,000 in 2003. When the tax preparer prepares the gift tax return next April, it comes out that the client made a substantial taxable gift in the early 1970's. Because the gift rate table (unlike the estate tax) takes into account all prior taxable gifts, including pre-1977, the client's unified credit of \$345,800 is not sufficient to shelter a gift of \$1,000,000, and a gift tax will be due. If the pre-1977 gift was \$2,000,000 or more, then the 2003 gift of \$1,000,000 will be entirely in the 49% bracket, generating a tentative tax of \$490,000. After applying the unified credit of \$345,800, the client will owe a gift tax of \$144,200!

In the other variation on this trap, the client tells the estate planner that she fully used up her pre-2002 applicable exclusion amount of \$675,000, and she wants to know how large a tax-free gift she can make in 2003. After ascertaining that she made no pre-1977 taxable gifts, the

planner informs her that she can make an additional \$325,000 in taxable gifts in 2003. In this case it turns out that the client not only exhausted her pre-2002 unified credit, but made additional substantial taxable gifts, paying a sizeable gift tax. As with the prior scenario, the client finds that her 2003 gift of \$325,000 results in a substantial gift tax because of bracket creep in the gift tax structure. When the unified credit jumped in 2002 from \$220,550 to \$345,800, that \$125,250 increase was designed to protect an additional \$325,000 of gifts only if the cumulative taxable gifts total only \$1,000,000. If the pre-2002 taxable gifts in excess of the then applicable exclusion amount exceeded \$1,375,000, then the entire 2003 gift of \$325,000 will be at the 49% bracket, resulting in a gift tax, after the unified credit, of \$34,000. The maximum amount the client could have given away tax free was only about \$255,000.

The moral is to be sure to ask the right questions, and to know what to do with the answers.

#### Estate Planning Mistake #4

##### Making General Assumptions as to Whether Clients Should or Should Not Incur a Gift Tax

In years gone by (i.e., before EGTRRA), there was a general principle that it was often cheaper to make taxable gifts and pay a gift tax, rather than to die with the assets and pay estate tax. This principle was based on the fact that the gift tax rates are effectively lower than the estate tax rates because the gift tax is “tax-exclusive” and the estate tax is “tax-inclusive.” In other words, the gift tax is imposed only on the property received by the donee, whereas the estate tax is imposed on all the property in the estate, including the estate tax itself.

Although this principle made sense as a generality, there were many situations where such taxable gifts were not desirable. For example, the loss of a basis step-up could outweigh the estate and gift tax benefits. Since the tax-exclusive nature of the gift tax disappears if death occurs within three years of the gift (see § 2035), a client could end up with a loss of a basis step-up without any compensating estate or gift tax benefit. Thus, even pre-EGTRRA, relying on a general principal would have been a mistake.

In our post-EGTRRA world, there is a general philosophy that gifts in excess of the applicable exclusion amount should normally not be made, because estate tax repeal is a reasonable likelihood seven years from now.

It is true that most clients would not want to pay a gift tax where they can avoid tax by holding onto property until their death. However, once again, it would be a mistake to follow that rule without looking at the client’s specific situation. For example, if a client is likely to live at least three years, but not until estate tax repeal, making a large taxable gift may make sense. Also, a client may simply want to make a large gift to children for non-tax reasons (such as business succession planning) and not want to wait until death (although it may in many cases be preferable to make low-interest loans to the children, forgivable at death). Lastly, in the case of a

state such as New York where the state death tax credit has been decoupled, a deathbed gift may defeat all or part of the state estate tax (as described above).

The only clear rule is that all rules have exceptions.

### Estate Planning Mistake #3

#### Failing to Allocate GST Exemption or Failing to Opt Out of Automatic Allocation

Prior to EGTRRA, there were many instances where the preparer of a client's gift tax return failed to effectively allocate GST exemption to a gift which was intended by the client and the estate planner to use the client's exemption. EGTRRA added new § 2632(c) which in essence defines certain types of trusts where GST exemption will automatically be allocated to any gift to the trust, unless the taxpayer "opts out" of this treatment on a gift tax return.

Although this legislation effectively eliminated the tax-preparation trap described above, it did it with a sledge hammer and provides for automatic allocation of GST exemption in many scenarios, including many insurance trusts, where the typical client would probably not want to allocate exemption. Accordingly, it is important for the client to opt out in those trusts so as to avoid wasting GST exemption. Furthermore, even for a trust where the client probably does want to allocate GST exemption, it is probably desirable for the client to opt out of automatic allocation, so that a sophisticated estate planner can, among other things, intentionally make a late allocation where the value of the transfer has decreased prior to the gift tax filing date. Of course, once the client has opted out, it is important for the planner to make sure that any desired allocations are properly made.

### Estate Planning Mistake #2

#### Funding a Credit Shelter Trust Through an Estate Distribution That Carries out DNI

Prior to the Taxpayer Relief Act of 1997, this was one of the most hazardous traps that an estate planner could face. Because of expansion in the 1997 Act of the separate share rule of § 663(c) to estates, the trap is not as hazardous, but remains out there. The current rule can best be understood by looking at the trap as it previously existed.

Consider a \$10,000,000 estate with a pecuniary formula credit shelter trust. For a 1996 estate the credit shelter amount would have been \$600,000. Assume that under state law the pecuniary credit shelter bequest does not share in estate income, and is entitled to interest after a certain date. A thoughtful post-mortem estate planner would seek to fund the credit shelter trust as quickly as possible, so that it would take advantage of income and appreciation on its \$600,000 corpus. However, if the credit shelter trust was funded in the first fiscal year (and no other distributions were made), and the estate had at least \$600,000 of distributable net income in that first year, there would have been a disastrous result – the \$600,000 distribution would have

carried out \$600,000 of DNI from the estate, making the distribution taxable income in its entirety. Thus, instead of having \$600,000 to invest, the credit shelter trust would have ended up with only about \$360,000 in corpus after payment of a 40% income tax.

The 1997 Act extended the separate share rule for trusts to estates, and the regulations specifically provide that a pecuniary formula disposition is a separate share. The consequence of being a separate share is that the estate's DNI is normally allocated to it only in proportion to the separate share's interest in estate income. Thus, since the credit shelter disposition in the example was not entitled to any share of estate income, ordinarily no DNI would be allocated to it. Thus the disaster described above will not happen under the current law.

However, there is a situation where DNI will still be allocated to the credit shelter trust in the example. The regulations create an exception to the general rule – that DNI is allocated proportionately to the right to income – where the estate receives income in respect of a decedent (IRD). In the case of IRD, the income is allocated among all of the estate's separate shares that could potentially be funded with the IRD, irrespective of whether a share is entitled to receive any share of fiduciary accounting income. The allocation is made based on the relative values of the separate shares.

Modifying the example somewhat, assume a \$10,000,000 estate in 2003 with a pecuniary formula credit shelter trust entitled to \$1,000,000. In the first fiscal year the estate funds the credit shelter bequest (and nothing else) and receives a \$1,000,000 deferred compensation payment and no other income. Unless the will prohibits the funding of the credit shelter trust with IRD, the credit shelter trust will have \$100,000 of DNI allocated to it, which impairs its value, but is not nearly the disaster as in the 1996 example. However, if the IRD is larger, say \$5,000,000, then the result gets worse – \$500,000 of DNI, reducing the value of the credit shelter trust by perhaps 20%.

Can these results be avoided? On the one hand, a prohibition in the will against funding the pecuniary formula bequest with IRD will probably be effective. If the will does not contain such a clause, then thoughtful post-mortem planning as to the selection of a fiscal year, the timing of distributions will allow the problem to be avoided.

### Estate Planning Mistake #1

[Drum Roll]

### Not Adequately Providing for the Uncertainty Created by EGTRRA

It is imperative that all estate planners review and revisit both the substance and the drafting of all their estate plans with an eye toward the uncertainties created by the passage of EGTRRA. Among issues to be considered are:

(a) How should the credit shelter amount be defined in light of (i) the increasing applicable exclusion amount, (ii) the potential repeal in 2010, (iii) the phase-out of the state death tax credit, and (iv) the enactment by states of independent estate taxes?

(b) In what form should the credit shelter bequest be held? If the estate tax is repealed, is there a need for a credit shelter trust?

(c) How can the \$1,000,000 applicable exclusion for gift tax best be utilized?

(d) How can flexibility be preserved if a testator becomes incompetent after execution of a will?

(e) How should carryover basis as of 2010 be factored into the will and other estate planning documents?

(f) How can an estate plan factor in the possibility that everything in EGTRRA is subject to change?

It is beyond the scope of this presentation to discuss estate planning under EGTRRA at length. It is a component of many current CLE programs. It is clear however, that not adequately taking the uncertainties of EGTRRA into account might be the biggest estate planning mistake that a planner could make in 2003.