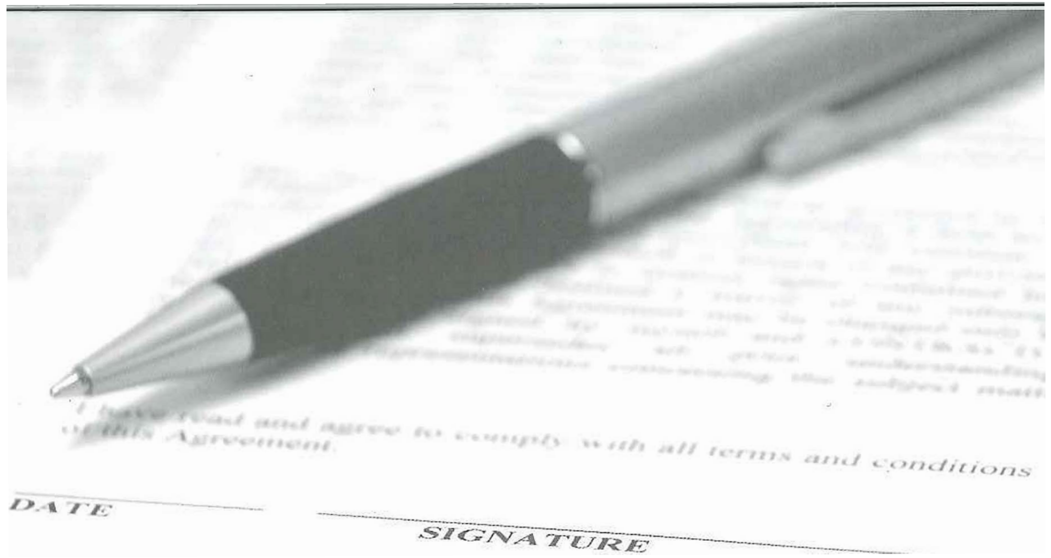

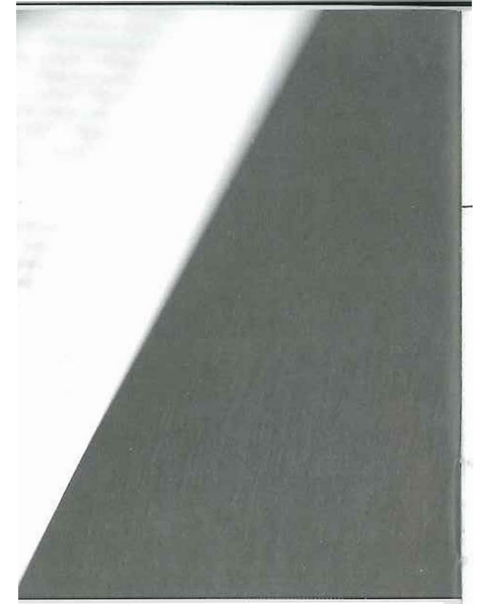

Basic Tips for the "Curiouser" World of Estate Planning

By Harlan Dodson & Candi Henry

I know who I was when I got up this morning, but I think I must have been changed several times since then. —Lewis Carrol, *Alice's Adventures in Wonderland*

Be Aware of our New Planning Landscape

Having spent our professional lives designing plans to avoid having assets included in a decedent's estate for estate or inheritance tax purposes, we now find that may no longer be the goal and, indeed, may be counterproductive. In coming to terms with the new planning landscape, practitioners may well feel as if they've fallen through Alice's Looking Glass. With apologies to the Cheshire Cat (and George Harrison), knowing which way to go depends on knowing where you want to get to… .

As of January 1, Tennessee no longer has a gift tax, inheritance tax, or estate tax. Further, we now have a federal estate and gift tax exemption of $5,450,000. Plus, we have "portability" of these exemptions as between spouses, so for most married couples, there is a combined exemption. For many clients today, our best planning opportunity is a mismatch between the income tax and the estate tax provisions. Although the federal exemptions are now historically large, section 1014 of the Internal Revenue Code still grants a stepped up basis to date of death value for most assets passing through an estate, even though they are not subject to estate tax.

Except where there is still a risk of estate taxation even with the high exemptions, the goal now may be to have the assets included in the estate at death. In this new universe, we can see the IRS agent arguing that an asset is *not* in the estate, and the Executor insisting that it indeed is *in* the estate. This means that a good first response is to revise the basic format of the wills or revocable trusts most planners have historically employed, since there are now certain fundamental issues with the traditional documents.

Watch out for Problems with Tennessee Marital Gap Trust Provisions

Tennessee planners had designed the "Tennessee Marital Gap Trust" as a clever way to deal with the "gap" between the federal estate tax exemption and the Tennessee inheritance tax exemption. This consisted of adding a separate qualified terminable interest marital trust equal to the amount by which the federal exemption exceeded the Tennessee exemption. Obviously, there is no reason to include that language in new wills. However, existing wills do need to be reviewed to determine the effect such gap language would have in view of our changed planning environment, especially where the existing will mandates a series of allocations to fund such a gap trust. While the changes to the federal exemption and portability had been in effect for several years, the fact of the Tennessee gap had delayed updating our forms here. With its passing, now is the time.

Consider for the Possibility of Problems with Bypass Trust Provisions

Prior to the recent addition of portability of the federal gift and estate exemptions between spouses, planners had to be certain to use the exemption of the first spouse to die. We did so by including an amount equal to the exemption (but not a penny more!) which would have been taxable, but for the exemption, in the estate of the first spouse to die. When combined with either an outright marital gift or a marital qualified gift in trust, the spouses were thus assured of the full availability of both exemptions and of deferring any estate or inheritance tax until the death of the second spouse. However, when utilizing the full exemption of the first spouse, it was also important to ensure that those assets would not then be again taxable in the second estate, which would only have a single exemption.

The solution which became a common element in everyone's will forms, often referred to as A and B trusts, was to first assign an amount of assets, up to the exemption amount, into a testamentary trust which was carefully worded so as not to be includable in the estate of the second spouse to die. Because the trust sheltered the assets used for the first exemption from the surviving spouse's estate, and bypassed that estate, they were commonly known as "credit shelter" or "bypass" trusts.

Problems with Overfunding

When the exemptions were fairly low, and avoiding inclusion in both estates critical, it made perfect sense to include some provision such as, "the largest amount which will… result in no Federal Estate Tax being payable by my estate," when defining the funding of the bypass trust. However, inevitably, this mandated that such amount would go into an irrevocable trust, rather than go outright to the survivor or children.

Now, with the higher exemptions, that means that up to the first $5,450,000 in that first estate goes into trust. That is likely to be an unpleasant shock to all concerned. This means that, for the very typical couple who would simply prefer to leave all to the survivor outright, unless estate taxes required a trust, the bypass trust is now generally an outdated and unnecessary relic which can create significant difficulties in the administration of the estate.

Loss of the Stepped Up Basis

As noted above, for most assets passing through an estate, there is a stepped up income tax basis to the date of death values. (Retirement accounts, installment notes, and certain other assets are exceptions.) That step up is available in each estate through which the asset passes.

For example, Mr. Smith buys an asset for $1,000, which has increased in value to $10,000 at his death and leaves it to Ms. Smith, she can sell it at any time and pay no tax on the proceeds up to $10,000. If it has increased in value to $20,000 at her death and she leaves it to her daughter, then the daughter can sell it at any time and pay no tax on the proceeds up to $20,000.

However, if the asset had gone into a bypass trust under Mr. Smith's will, then it would not have been taxable in Ms. Smith's estate and the second step up would not have been available. Given the increasing likelihood of longer life for surviving spouses, the appreciation in value over her lifetime may well be significant, and so would the unneeded tax burden.

Again, what once was good practice would now be actually harmful!

The world of estate planning keep getting "curiouser and curiouser." But, a review of forms and goals will help planners avoid going as mad as the Hatter. ■

***Harlan Dodson** is a partner with Dodson Parker Behm & Capparella, PC in Nashville. He has taught wills and estate planning at the Nashville School of Law for over 30 years and is an editor of West Publishing Company's Tennessee Practice Series volumes on business formation and estate planning. He is also author of the text* Introduction to Estate Planning and Administration in Tennessee.

***Candi Henry** is a partner with Dodson Parker Behm & Capparella, PC. She serves as Instructor of Legal Research and Writing at Nashville School of Law and yet still doesn't have the slightest idea why a raven is like a writing desk.*