New Jersey Law Journal

VOL. CLXXXVII– NO.6 – INDEX 420 FEBRUARY 5, 2007 ESTABLISHED 1878

# Estate Planning

## Baby Boom Legacy

### With estate taxes likely to fluctuate, planners are wise to focus on nontax objectives

By Steven L. Friedman

The likely legacy of the baby boom generation will be the policy changes needed to ease the strain placed on our health care and social service systems. The first baby boomers will become eligible for Social Security retirement benefits in less than a year, with 78 million more to follow, at the rate of 7,918 per day. They are also enjoying increased longevity, evidenced by the growth of the 65-plus and 85-plus populations.

When the Graying of America became part of our vocabulary 25 years ago, both age groups were at historical highs. Over the past 25 years, the 65-plus group has grown 40 percent faster than the general population and is expected to grow four times faster than the general population over the next 25 years, with more than one in five Americans in that age group.

Over the past 25 years, the 85-plus group has grown four times faster than the general population and is expected to maintain that pace for the next 25 years, when the first baby-boomer will turn 85. Over the subsequent 20 years, that age group will grow eight times faster than the general population, until it represents-25 percent of the 65 plus population.

As our population ages, the worker-to-retiree ratio will drop to two-thirds of its current level. A recent report from the Social Security trust fund estimated that depletion will begin within 10 years, with the fund completely depleted only 23 years later. The cash needed to secure the fund for 75 years is now estimated at $4.6 trillion dollars, $600 billion more than last year.

As a nation of immigrants, we have a long history of demographic changes, but never this big or this fast. The baby boomers will influence fiscal policy for the next 50 years, making permanent federal estate tax change highly unlikely.

The federal estate tax debate is likely to remain, as it continues to be a useful political rallying point. Opponents have labeled it the “death tax” and have expressed deep concern for its impact on family businesses and farms. Supporters rally their constituents to fight against the class warfare suggested by estate tax repeal. Given the changing demographics and the unpredictability of political decisions, a permanent, viable and rational solution to the estate tax seem unlikely.

For 20 years, the structure of the federal estate tax remained largely unchanged until the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Because the act altered the structure of the tax and because the changes were temporary, conventional wisdom was that Congress would soon make the changes permanent. The aging baby boomers, budget deficits, the war in Iraq and Democratic majorities in Washington now seem to make permanent repeal highly unlikely. The continued uncertainty will make estate and gift tax planning more complex than ever before.

Over its 10-year life span, EGTRRA imposes eight rate changes and six changes to the federal estate tax exemption. In addition, it repeals the tax for individuals who die in 2010, and replaces the tax with complex modified carryover basis rules. For individuals dying after 2010, the estate tax returns with a $1 million exemption and rates at pre-EGTRRA levels.

EGTRRA also eliminated the federal credit for state death taxes, replacing it with an exemption and eliminating the historical connection between the state and federal estate tax systems. Many states, including New Jersey, imposed a state estate tax equal to the federal credit, reduced by any inheritance tax payable. Under that structure, the state estate tax did not increase the overall tax liability of an estate. It merely required estates to pay a portion of the federal tax to the states.

Repeal of the federal credit left New Jersey without an estate tax, prompting the legislature to make the estate tax independent of the federal tax. Without the federal credit, however, the state estate tax increases an estate’s overall tax liability, eroding the benefit of the temporary rate

*Friedman is chair of the trusts and estates Group at Stark & Stark of Princeton.*

This article is reprinted with permission from the FEBRUARY 5, 2007 issue of the *New Jersey Law Journal*. ©2007 ALM Properties, Inc. Further duplication without permission is prohibited. All rights reserved.

reductions and exemption increases.

While many states have adjusted their estate tax in reaction to EGRTTA, the adjustments have not been consistent from state to state. Planners should evaluate the inheritance and estate tax laws of every state in which clients own property and offer counsel regarding the potential benefits of a domicile change.

Planning for married couples has also been severely impacted. A common federal estate tax reduction technique is to divide a deceased spouse's estate into two trusts. A nonmarital trust is funded with the maximum amount permitted without incurring any federal estate tax liability. The marital trust is funded with the deceased spouse's remaining assets.

The marital trust is exclusively for the benefit of the surviving spouse, designed to qualify for the federal estate tax marital deduction. The marital trust will be included in the surviving spouse's taxable estate. The nonmarital trust is designed to use the deceased spouse's federal estate tax exemption and to avoid having any part of it included in the surviving spouse's taxable estate. Although not required, the surviving spouse may also be a beneficiary of the nonmarital trust.

Fluctuation in the federal exemption and repeal of the federal credit for state death taxes make marital trust planning extremely complex, because of the uncertainty as to the amounts that will be allocated to each of the trusts upon the spouse's death. For a 2007 estate, a typical plan could fund the nonmarital trust with the current federal exemption of $2 million, producing an immediate $99,600 New Jersey estate tax liability. Alternately, the plan could fund the nonmarital trust with only $675,000, deferring all tax liability until the surviving spouse's death.

The correct choice depends on whether protecting an additional $1,325,000 ($2 million minus $675,000) from federal estate taxation in the future justifies the $99,600 payment. That, in turn, depends on estate tax laws in existence at the time of the surviving spouse's death, the family assets at the time of the first spouse's death and the surviving spouse's life expectancy. Without the ability to predict the future, a viable mechanism must exist to defer that decision for as long as possible

If the first spouse died in 2010, the year of repeal, the nonmarital trust would receive all of the deceased spouse's assets — the maximum permitted without incurring federal tax. That funding could inadvertently disinherit a surviving spouse who was not a beneficiary of the nonmarital trust.

The only certainty may be the continued uncertainty for the foreseeable future. The best way to counter that uncertainty is by designing estate plans with increased levels of flexibility. That requires the client to focus exclusively on nontax objectives. Some of the most effective ways of increasing flexibility are described below.

*Fiduciary Provisions:* Some methods of enhancing the trust's flexibility through the powers of the fiduciaries are:

1) Vest the trustee with broad fiduciary distribution powers, consistent with the client's objectives. This type of enhanced power can be limited to certain beneficiaries and can be made subject to third-party approval.

2) Bifurcate the trusteeship, appointing family members to make investment decisions and give broader distributive powers to an independent co-trustee

3) Give the fiduciary expanded administrative and investment powers.

4) Provide for resolution of deadlocks among co-fiduciaries.

5) Provide for fiduciary succession, including appointment of co-fiduciaries, removal and replacement of acting and successor fiduciaries, and appointment of special or substitute trustees.

6) Designate a trust protector with the power to remove and replace trustees and to block investment and distribution decisions of the trustee.

7) Permit the trustee to appoint a substitute trustee.

*Power of Appointment:* Limited powers of appointment can add significant flexibility by allowing a beneficiary to direct the distribution of trust assets, either during the beneficiary's lifetime or following death. The distribution can be to one or more of a group of persons, provided that none of them include the power holder, the power holder's estate, the power holder's creditors or the creditors of the power holder's estate. Exercising a limited power of appointment will not cause the trust funds to become part of the beneficiary's estate. The power could permit changes to the trust provisions, the terms under which the trust assets are held, and the beneficiaries of the trust.

*Disclaimers:* In addition to individuals, fiduciaries may be given the power to disclaim assets payable to the trust without court authorization. N.J.S. 3B:9-4. Qualified disclaimers must be in writing, executed and filed within nine months after the decedent's death, and completed before the disclaimant has accepted any benefits from the disclaimed assets. Disclaimers can work in marital trust planning, but only if the beneficiaries of the nonmarital share are the same as the surviving spouse's beneficiaries. To the extent disclaimed assets are used to fund the nonmarital trust, the surviving spouse must also disclaim any limited powers of appointment held over that trust.

*QTIP Trust:* Another method of funding the nonmarital trust is to leave the estate to a marital QTIP trust. The trustee is instructed to divide the trust in a way that maximizes use of the deceased spouse's estate tax exemption. This technique requires the surviving spouse to be the only beneficiary of both trusts.

*Clayton QTIP:* A *Clayton* election allows the trustee to allocate to the marital trust only the amount for which a QTIP election is made. *Estate of Clayton v. Comm'r.*, 976 F2d 1486 (5th Cir. 1992), rev'g and remanding 97 TC 327 (1991). The other portion of the trust is held in the nonmarital trust. The latest deadline for the *Clayton* election is 15 months after death.

*Business Entities:* Additional flexibility is also available by having the trust's assets owned by a Limited Liability Company or Limited Partnership. The trust would own the entity, but the client would still manage the company. ■