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# Tax Memo

## FEDERAL ESTATE TAX - A BRAVE NEW WORLD

As this article goes to press, we have no federal or Kansas estate, generation skipping, or death taxes with which to contend. We also now have "carryover" tax basis for assets inherited at death (with limited exceptions). By inaction, Congress has allowed the federal estate tax, the federal generation skipping tax and the law which gave taxpayers a step-up in tax basis for almost all inherited property to effectively expire as of January 1, 2010. The stand-alone Kansas estate tax expired for estates of persons whose death occurs after December 31, 2009. However, relief is only short term. Beginning on January 1, 2011, we are back to a \$1,000,000 federal estate tax exemption and a progressive estate tax rate topping out at 55%. Further, taxpayers who receive property will again be able to "step-up" the basis to its fair market value. How did we get into this mess?

The current federal estate tax dates back to 1916 when Congress first imposed a tax on estates of decedents who died with assets in excess of \$50,000. However, for income tax purposes, the heirs got a tax basis equal to the value of the

property at death. In 1976, Congress effectively merged the federal estate and gift taxes, and imposed one exemption amount for both (approximately \$176,000). Gradually, over the years, the exemption amount was increased by various Congressional acts, and a special tax on generation skipping transfers was enacted. The 1998 legislation resulted in an exemption of \$675,000 but provided for a phased increase of the exemption amount to \$1,000,000. After the election of President George W. Bush in 2000, Congress changed the law again. The 2001 Act provided for a phased in increase in the exemption amount which reached \$3,500,000 in 2009. The 2001 Act also provided for the complete repeal of the tax in the year 2010 and eliminated the popular "step-up" in tax basis to fair market value (with some exceptions). However, for procedural reasons, the 2001 Act had a limited 10-year life. The 2001 Act had a sunset provision that expires on December 31, 2010. Thus, the law in effect *prior* to the 2001 Act will, if no other legislative action takes place, become the law again *on January 1, 2011*.

None of us in the estate planning community expected to get to the

end of 2009 without some additional Congressional action. It is not as if Congress was unaware of this problem. There were several bills pending in Congress that address this important tax issue. Those bills are still pending, and they run the gauntlet from a decrease in tax to an increase in tax. Some also eliminate various tax savings techniques we often use.

It appears that fixing the estate tax permanently is simply not yet a high priority item to Congress. There are many who now predict that Congress will impose a temporary, one-year "patch" on the estate tax; make the "patch" retroactive to January 1, 2010; and will then take up the subject and pass permanent legislation that will make the tax for 2011 and thereafter similar to the tax rate and exemptions that existed for 2009. There are others who are predicting that the partisan logjam in Washington will result in no action this year, and that we will see the law revert to its status prior to the 2001 Act, in other words, a \$1,000,000 exemption and a rate that reaches 55%. And, there is some question as to whether a tax can be constitutionally retroactively imposed.

What's a taxpayer to do? Obviously, the current situation makes planning extremely difficult. Taxpayers need to review their Wills and Trusts and determine if the provisions of their instruments which control the disposition of their property are still what they want in light of the current law. For example, if an individual has a Will which gives his children "the maximum amount that can pass free of estate tax," that will likely mean his children receive all of his property if he dies in 2010. If they have planned for a maximum generation skipping gift, it is now uncertain exactly what that amount may be. Again, it could be all of the estate assets. This may mean a spouse, who was to receive everything in excess of these amounts, now will not receive anything. And, the situation may change again on January 1, 2011!

Many instruments may not need to be changed, but all taxpayers with significant estates should probably review their documents. If instruments are drafted with "formula clauses" for marital gifts, then the instruments may need to be redrafted or changed. Individuals may also want to consider what effect the loss of a "step-up" in income tax basis may mean to their children after the death of the individual.

This is a complicated and fast changing tax area. The stakes are very high. We encourage impacted taxpayers to keep abreast of the news in this area, and call the professionals at Bever Dye with any questions they might have.

## RETIREMENT PLAN DISTRIBUTION TRAPS

Often taxpayers and their advisors do not give enough consideration to properly planning for retirement plan distributions. Unfortunately, it is common and easy to make mistakes in this regard. Items discussed below apply equally to employer-sponsored tax-qualified retirement plans (such as profit sharing plans, 401(k) plans and ESOPs) as well as IRAs (although certain IRA rules are different and will be noted). For simplicity, this article will refer to all the foregoing tax-qualified retirement plans and IRAs as simply "plans."

One of the common mistakes is to name the surviving spouse as the "Designated Beneficiary" (DB) of plan assets. This can create problems in the typical estate plan where the decedent has two trusts, one of which is a "Credit Shelter Trust" (CST) and the other of which is a "Marital Trust" (MT). A CST, also often called a Family Trust, is designed to make maximum use of the decedent's federal estate tax exemption. To accomplish this, there must be sufficient assets to fund the CST to the maximum possible extent. If assets are given directly to the surviving spouse, there may be insufficient assets to fund the CST to the maximum possible amount, and some or all of the decedent's federal estate tax exemption may be wasted. There may be the possibility of correcting this problem with a qualified disclaimer, but the rules are technical and there are time limits within which this can be done.

If the estate plan avoids the problem with naming the surviving spouse as the beneficiary by

designating the CST as the beneficiary, additional problems may arise. First, many people are not aware that plans generally require the spouse's consent to a beneficiary designation to a person or trust other than the surviving spouse. This rule applies only to an employer-sponsored retirement plan such as those mentioned above. This is one area in which the IRA rules are different. IRA beneficiary designations do not require spousal consent. If the spouse does not consent to the designation of the CST (or MT for that matter) as a beneficiary of an employer-sponsored plan, the spouse may take the benefits directly and override the ability to adequately fund the CST.

A second problem with naming a CST is that it is better not to direct plan benefits to a CST if the decedent has other non-plan assets with which to fund his or her CST. The goal of a CST is to keep the assets from being in the decedent's taxable estate and also the surviving spouse's taxable estate. If drafted properly, a CST may avoid taxation in both estates. Because plan assets are subject to both income tax and estate tax, it is better not to fund the CST with plan assets if possible. This is because the CST will be depleted by the income tax applicable to the plan assets, resulting in a lower CST value which will escape estate taxation in the surviving spouse's estate. The CST value should be maximized if possible. In this circumstance, it is better to direct plan assets either directly to the surviving spouse or to the MT, assuming there are sufficient non-plan assets with which to fund the CST. There are ways to design beneficiary designations to account for these considerations.

As noted above, it is better to name the MT as the beneficiary of plan assets rather than the CST if there are sufficient non-plan assets with which to fund the CST. Naming the MT, however, is not without risk either. The MT (also often called a QTIP trust) rules require that all of the plan's annual income flow through the MT to the surviving spouse. This is to comply with the general rule that the surviving spouse is entitled to all of the income of the MT. It is critical that the MT be specifically designed to achieve this result. This, too, is often overlooked.

One final concern relates to the usual goal to pay benefits from the plan over the longest possible period of time for income tax purposes. This is desirable to make use of the tax-deferred buildup within the plan. Generally, an individual named as a DB qualifies for a lengthy payout (related to his or her life expectancy). A common mistake is to name an estate as a DB. An estate does not qualify as a DB, in which case all benefits must be paid within five years. Also, a charitable organization does not qualify as a beneficiary. The surviving spouse is a DB qualifying for the lengthy payout (related to his or her life expectancy). In certain circumstances, trusts may be permitted to use a lengthy payout related to life expectancy of a beneficiary. If the plan assets are directed to a CST, an MT, or both, technical rules may be met to permit the distribution to be paid over a period of time as long as if a person was named as the DB. If these rules are met, the life of the oldest trust beneficiary may be used. Often the oldest trust beneficiary is the surviving spouse (or perhaps the oldest child if the spouse is not a trust beneficiary).

In order to use these rules and "look through" the trust instrument to the life of the oldest trust beneficiary, certain rules must be met. The trust must be valid under state law, beneficiaries must be identifiable from the trust instrument, the trust must be irrevocable (or by its terms becomes irrevocable on the death of the plan participant), and trust documentation must be provided to the "plan administrator" after the date of death. This information must be furnished to the plan administrator by October 31 of the calendar year following the calendar year in which the decedent died. Again, there are technical rules for meeting these requirements.

To use the life expectancy-related payouts, the DB must be a natural person or a trust meeting the rules set forth above.

The foregoing are some of the common ways in which plan distribution planning can present problems. All of these rules are complex, and this article only provides a general overview. This article should not be relied upon as governing a particular factual situation. The attorneys at Bever Dye are well qualified to address these questions and concerns.

#### **DETAILED FEE DISCLOSURES FOR 401(k) PLAN PARTICIPANTS**

The Department of Labor (DOL) has taken action in response to investigations and reports issued by Congress, the Securities and Exchange Commission and the DOL itself regarding lack of fee disclosures by plan service providers. The DOL now requires more detailed fee disclosures on Form 5500, Schedule C, which is the

publicly available annual report that plans subject to the Employee Retirement Income Security Act ("ERISA") are required to file.

Moreover, the DOL, through the Employee Benefits Security Administration, has proposed new regulations for participant-directed plans, such as self-directed 401(k) plans. Such plans allow participants to choose how their account assets are invested. The proposed regulations under ERISA would require that a fiduciary (such as an employer) provide participants and beneficiaries in participant-directed plans with plan and investment-related information generally on an annual basis. This information would include details of fees and expenses assessed to participants' individual accounts. The proposed rules would specifically require the disclosure of investment-related fee and expense information (e.g., sales loads, sales charges, redemption fees, surrender charges, exchange fees, account fees, purchase fees, and the expense ratio for the total operating expenses of the investment). Disclosure must be made in a chart or similar format that would allow for a comparison of the plan's investment options.

One area of exposure for plan sponsors will likely be the amount of information that they are required to disclose to plan participants. ERISA traditionally has required a certain level of participant education and disclosure regarding investment options. Plan sponsors have been required to distribute plan prospectuses, but they did not need to explain in detail each element of plan fees that are paid by participants. However, as stated above, the DOL's recent proposed regulations require that all fees be disclosed, and that they detail the

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additional items that must be disclosed to plan participants. Examples of required disclosures include how to give investment instructions under the plan, the investment returns of each fund option, the amount of all fees and expenses charged to participants and how participants can obtain more detailed investment information. The proposed regulations would require that these details be provided to plan participants on a regular basis.

The regulations were issued in proposed form and the DOL may modify certain provisions of the proposed regulations. Nevertheless, it is likely that the rules set forth in the proposed regulations will be largely unchanged. It is unclear when final regulations will be released, but

whatever modifications are made in the final regulations, it is clear that fiduciaries of participant-directed individual account plans will need to provide more frequent and detailed disclosure of investment and fee information to comply with their fiduciary duties. The proposed rules serve as a roadmap as to what will constitute adequate disclosure from plan fiduciaries once the regulations are finalized, and plan fiduciaries should begin to think about how best to assure compliance with the new rules once they become effective. The tax professionals at Bever Dye are available to discuss such issues should you have any questions.

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