Advanced Strategies
FOR THE TAX ADVISOR
2nd Quarter 2010

Author: John Gephart, JD, CLU, Second Vice President, Advanced Sales

STATES ACT TO REMEDY ESTATE TAX UNCERTAINTY

Since Congress failed to act on the federal estate tax in 2009 it "sunset" in 2010 pursuant to the Economic Growth Recovery Act of 2001. No estate tax means no unified credit and no unlimited marital deduction. One consequence of this is that wills using formula clauses that work well when the estate tax is in force may produce unintended tax consequences when there is no estate tax. Specifically, there are issues as to how formula clauses in wills and trusts using estate or generation-skipping transfer (GST) tax terms (e.g., "the applicable exclusion amount," or "the marital deduction") will be construed, if the decedent dies in 2010.

Several states have addressed this situation by enacting statutes providing a special rule of construction under which formula clauses that refer to certain estate and GST tax terms generally will be construed as referring to the federal estate tax and GST tax laws which applied to estates of decedents dying on December 31, 2009. As of this writing, the following states have enacted such statutes:

- Indiana (Indiana Code S. 29-1-6-1(n)
- Maryland (Md. Code Ann. Est. & Trusts S. 11-110)
- Nebraska (L. 2010, LB1047)
- Utah (Utah Code Ann. S 75-3-917)
- Virginia (VA. Code Ann. S 64.1-62.4)
- Washington (L. 2010, S6831)
- Wisconsin (L. 2010, S670)

"No estate tax means no unified credit and no unlimited marital deduction. One consequence of this is that wills using formula clauses that work well when the estate tax is in force may produce unintended tax consequences when there is no estate tax."

Statutory Rule of Construction

The statutes enacted by all of the states listed above are substantially similar. However, they differ in some details, so a practitioner who is interested in the law of a particular state should carefully check the statutory language enacted by that state.

Under the statutory rule of construction, the will or trust of a decedent, who dies after Dec. 31, 2009, and before Jan. 1, 2011 will be deemed to refer to the federal estate tax and GST tax laws as they applied to estates of decedents dying on Dec. 31, 2009, if the will or trust contains a formula that:

1. Refers to certain estate and GST tax terms. For example, under the Indiana and Virginia statutes (which contain the most comprehensive list of terms), the statutory rule of construction applies to any formula clause that refers to the "unified credit," "estate tax exemption," "applicable exemption amount," "applicable credit amount," "applicable exclusion amount," "generation-skipping transfer tax exemption,"

The Ostrove Group

4 New King Street
White Plains, NY 10604

Phone: 914.428.4095
Fax: 914.428.6112
www.ostrovegroup.com

"GST exemption," "marital deduction," "maximum marital deduction," "unlimited marital deduction," "inclusion ratio," "applicable fraction," or any section of the Internal Revenue Code relating to the federal estate tax or GST tax;

2. measures a share of an estate or trust based on the amount that can pass free of federal estate taxes or the amount that can pass free of federal GST taxes; or
3. is otherwise based on a similar provision of federal estate tax or GST tax law.

The statutory rule of construction does not apply to a will or trust that is executed or amended after Dec. 31, 2009, or that manifests an intent that a contrary rule will apply if the decedent dies on a date on which there is no then-applicable federal estate or GST tax.

If the federal estate or GST tax becomes applicable before Jan. 1, 2011 (i.e., if Congress reinstates the estate and/or GST tax before the date on which those taxes will return unless there is a change in the law), the reference to "Jan. 1, 2011" in the statutory rule of construction will refer instead to the first date on which the federal estate or GST tax becomes legally effective.

"The statutory rule of construction doesn't necessarily resolve all of the ambiguities that can result from the temporary repeal of the estate tax in the way in which the testator would have wanted them resolved. The rule simply provides a uniform approach to construing formula clauses in the wills and trusts of decedents who die in 2010, without having amended their wills or trusts to address the temporary repeal of the federal estate and GST taxes."

The personal representative or any affected beneficiary under the will or other instrument may bring a proceeding to determine whether the decedent intended that the formulae be construed with respect to the law as it existed after December 31, 2009. The time period within which such a proceeding must be brought varies from state to state.

The statutory rule of construction doesn't necessarily resolve all of the ambiguities that can result from the temporary repeal of the estate tax in the way in which the testator would have wanted them resolved. The rule simply provides a uniform approach to construing formula clauses in the wills and trusts of decedents who die in 2010, without having amended their wills or trusts to address the temporary repeal of the federal estate and GST taxes. This uniform approach is designed to eliminate (or at least minimize) costly litigation to establish the testator's intentions about how the formula clause should be construed, in the absence of the federal estate tax.

If a testator doesn't want the statutory rule of construction to apply for a formula clause in his will or trust, then he should amend his will or trust to clarify his intentions about how the formula clause would apply in the event of his death before the federal estate tax is reinstated.

Examples of Formula Clauses

Formula clauses are designed to work in many different ways. The statutory rule of construction is written broadly enough to apply to all of the usual types of formula clause. The following illustrations provide examples of three different types of formula clauses, and show both (a) how each formula clause will be construed under the statutory rule of construction, if the decedent dies in 2010, and (ii) how each formula clause would have been construed without the statutory rule, if the decedent died in 2010. All of the illustrations assume that (i) the decedent dies in 2010, (b) the federal estate and GST taxes have not been reinstated by the date of the decedent's death, (iii) the decedent's will was executed before 2010, and (iv) the decedent's will was not amended after 2009.

Example 1: A decedent's will contains a formula clause which leaves, to the nonmarital share, the largest amount that can pass without federal estate tax in the decedent's estate, and leaves the residue of the estate to the decedent's spouse.

Under the statutory rule of construction, $3.5 million (the amount that could pass without federal estate tax in 2009 as a result of the unified credit) goes to the nonmarital share, and the residue of the estate goes to the decedent's spouse. Without the statutory rule of construction, the entire estate would have gone to the nonmarital share, because, in the absence of a federal estate tax in 2010, the entire estate can pass free of federal estate tax in 2010.

Example 2: A decedent's will contains a formula clause which leaves, to the nonmarital share, an amount equal to the applicable exclusion amount allowable to the decedent's estate, and leaves the residue of the estate to the decedent's spouse.

Under the statutory rule of construction, the result is the same as in Illustration (1), above: $3.5 million (the applicable exclusion amount that was allowed in 2009) goes to the nonmarital share, and the residue of the estate goes to the decedent's spouse. Without the statutory rule of construction, the entire estate would have gone to the decedent's spouse because, in the absence of a federal estate tax in 2010, there is no "applicable exclusion amount" by which the nonmarital share could be measured.

Example 3: A decedent's will contains a formula clause which leaves, to the decedent's spouse, the smallest amount necessary to reduce the federal estate tax on his estate to zero, and leaves the residue of the estate to the decedent's children.

Under the statutory rule of construction, the result is essentially the same as the results in Illustrations (1) and (2), above: the residuary estate of $3.5 million (the amount exempted from estate tax by the unified credit in 2009) passes to the children, and the amount by which the estate exceeds $3.5 million (i.e., the amount for which a marital deduction would have been needed to reduce the federal estate tax to zero in 2009) passes to the decedent's spouse as a pre-residuary bequest. Without the statutory rule of construction, the entire estate would have passed to the children, because, in the absence of a federal estate tax in 2010, no marital deduction would be needed to reduce the estate tax to zero.

DOES YOUR CLIENT'S SPLIT DOLLAR PLAN HAVE AN EXIT STRATEGY?

A split-dollar arrangement will eventually fail without an exit strategy designed to repay the obligation to the premium payor because:

- The taxable term cost grows every year. What started out as low cost increases over time, making the rates at older ages disadvantageous. For example, $1 million of at-risk death benefit for a 65 year old is $13,510; for a 70 year old, $20,620; for a 75 year old, $33,050 and for an 80 year old, $54,560. If the policy is second to die and one of the insureds dies, the taxable term cost is the single life rate under Table 2001. In our previous example of a 49 year old and 45 year old with $8 million of death benefits and a premium of $55,000, if one dies and the survivor is 70 years old, the taxable term rate is $165,960 for that year.
- If annual loans are made, each loan is made at a new rate. Additionally, if a loan is renewed at the end of its term, it renews at the rate then in effect. If interest accrues the interest due later on is quite substantial and may wipe out the death benefit when the loan and the interest are repaid.

Effective exit strategies for both economic benefit and loan arrangements create a fund to prepay the obligation during the insured(s)' lifetime(s) and pay future premiums thereafter, if any are due.

"Effective exit strategies for both economic benefit and loan arrangements create a fund to prepay the obligation during the insured(s)' lifetime(s) and pay future premiums thereafter, if any are due."

The following are possible strategies:

- Use annual exclusion gifts. This is useful if the premium is greater than the available gifting (that's the reason you use split dollar) but any funding will help, especially if it can be invested successful. Note that making gifts to pay the interest will, under an unusual provision of the regulations, result in the transaction being subject to IRC Section 7872, even if interest is being paid at the AFR.
- For loan arrangements, consider (for an additional premium cost) a policy with an increasing death benefit that mirrors the increasing liability. Many companies have a return of premium rider that can be increased each year by a fixed percent. Model the policy to see if there are restrictions on the amount and/or duration of the additional death benefit.
- Use a GRAT with the ILIT as remainder beneficiary, which can provide funds if the GRAT is successful. Note that, because of the estate tax inclusion period rules, this strategy is not useful for GST's; as an alternative, consider an installment sale to the ILIT if the trust has generation skipping implications.
- Make a large initial loan (with interest accrued at the AFR) to cover all future premiums. If the money is invested and earns more than the interest and premiums due there will be enough in this side fund to repay the loan at the death of the insured without touching the insurance death benefit. This works best if the loan is to an ILIT that is a grantor trust from the lender's point of view, so that taxes do not reduce the trust's return and the interest accruing to the lender isn't taxed.
- If an economic benefit arrangement is used, switch to a loan arrangement when the economic benefit is greater than the interest that will be paid on the loan. All the premiums previously advanced and any cash value above that amount will be the initial amount of the loan in the year of conversion.

Periodic review of plan performance is critical to the long term success of split dollar plans. Collaboration with the client's insurance professional who installed the plan is a key partner in that process.

The information presented here is not intended as tax or other legal advice. For application of this information to your specific situation, you should consult an attorney. Contact your representative for more information and assistance in obtaining life insurance and other products to help meet your financial planning needs.

This material is provided by UNIFI Companies for use by both affiliate and independent agents.

UNIFI Companies is a marketing name for subsidiaries of UNIFI Mutual Holding Company, including: Ameritas Life Insurance Corp., First Ameritas Life Insurance Corp. of New York, Acacia Life Insurance Company, The Union Central Life Insurance Company, and Ameritas Investment Corp., member of FINRA/SIPC. UNIFI Companies is not an insurance company or a licensed financial services company. Ameritas Life Insurance Corp. and Acacia Life Insurance Company are not licensed in New York. Each UNIFI Company is solely responsible for its own financial condition and contractual obligations. For more information about UNIFI Companies, visit www.UNIFIcompanies.com.

Second Quarter 2010 • Advanced Strategies is published quarterly.

Securities and advisory services offered through affiliate Ameritas Investment Corp., Member FINRA/SIPC.