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Guest contributor:  
Jim Blase

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## 2008 2<sup>nd</sup> Quarter Review

The 2<sup>nd</sup> quarter began with generally positive market sentiment after leading economic indicators appeared to have bottomed and economic data did not look as bad as many had expected. However, that positive sentiment faded in June as financials were trading down sharply and the S&P 500 posted its worst month of June performance since 1930.

Although the major indices entered bear market territory, the MSAM Growth composite gained back most of the ground lost in the first quarter. Updated performance numbers are available on the MSAM website:

<http://www.msam.net/products.htm>.

Harvesting some gains in the technology sector, having a few mergers get completed, and maintaining a level of cash sufficient to offset market weakness helped produce very good results in lieu of the market environment.

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## 2008 3<sup>rd</sup> Quarter Preview

The current economic environment continues to appear weak. However, a few items of note are:

1. While leading indicators like ECRI's Weekly Leading Index are not pointing to a reacceleration in growth, they are not getting any worse either, and have bounced off of their 1<sup>st</sup> quarter lows.

2. The Federal Reserve looks to be on the sidelines with interest rates for the time being, and its policies continue to be supportive of business.

3. Second quarter earnings results have begun to come in and validate that corporate results are weak, but not terminal, in most cases.

Nowhere does this "weak, but not terminal" message seem clearer than in the financials. Sheila Bair, chairwoman of the FDIC, recently indicated in an interview that there were around 100 banks on their "troubled bank" list. This compares to around 1500 on the list in 1989. They closed 534 banks that year. Less than 10 this year. We may yet see more deterioration in the fundamentals of the sector. But with a full year now of write downs and adjustments, our belief is that we're much nearer the end than the beginning of this cycle. Additionally, with the U.S. government's implicit guarantee of survival for Fannie Mae and Freddie Mac, there do not appear to be any great shoes left to drop for the financials. This sets up the sifting process where our research can identify opportunities, separating the good from the bad, since the selling has taken down most financials, deserving or not.

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## Estate Planning in an Uncertain Estate Tax Environment

### Contact Us

Ron Medley  
rmedley@msam.net

Michael Hieger

13537 Barrett Parkway  
Drive, Suite 300  
Manchester, MO 63021  
800-628-6002, x3003  
Fax: 314-909-0606  
<http://www.msam.net/>

While the investment process dominates our work, estate planning questions often come up. If we do a good job growing an estate's investment portfolio over the years, but it is then subject to a great estate tax burden, then it is unlikely that we've successfully achieved a client's goals and helped that client to best express their values with their money, in life and beyond.

With a number of uncertainties in the current estate tax laws, it is easy to get stuck in the process of developing estate documents. Rather than a wait and see approach, one solution is to put the estate plan together in a flexible manner which can adjust to the changes in the laws. Jim Blase, a local expert estate planning attorney, whose experience and client relationships span decades, offers some perspective on how to do that in the following article he has contributed. One shouldn't be afraid to seek outside help to get started, review, or get unstuck in the estate planning process. A flexible estate plan can offer great piece of mind.

## Estate Planning in an Uncertain Estate Tax Environment

### \$3.5 Million Exemption, Repeal, \$1 Million Exemption, or Other?

By

James G. Blase, CPA, JD, LLM  
Blase & Associates, LLC  
12429 Nicholas Lane  
St. Louis, Missouri 63131  
314-909-6565  
Fax: 314-909-6523  
Email: [jimblase@blaselaw.com](mailto:jimblase@blaselaw.com)

#### Introduction

Estate planning for married couples during the second half of 2008 and into calendar year 2009 has become more important as a result of the projected rise in the federal estate tax exemption. Whereas couples with “small” estates (in relation to the \$2 million and upcoming \$3.5 million federal estate tax exemption) will no doubt now want to take advantage of the likely larger estate tax exemption in order to simplify their estate planning, provide maximum protection from potential law suits, and reduce income taxes to their heirs, couples with “large” estates (in relation to the \$2 million and upcoming \$3.5 million exemption) now need to focus much more on a proper division of their assets in order to take maximum advantage of the likely larger estate tax exemption, which may also require them to examine new alternatives for protecting their newly-divided assets from potential lawsuits.

Estate planning has become the most challenging for the vast majority of married couples who have “medium-sized” combined estates (in relation to the \$2 million and upcoming \$3.5 million federal estate tax exemption), or roughly \$1 million to \$3 million in assets, including life insurance, IRAs and qualified plan benefits. Estate planners now need to examine these situations on a case-by-case basis, making sure that the clients not only minimize or eliminate their estate tax exposure, but do so in a manner which will not result in unnecessary income taxes or capital gains taxes, and which will not unnecessarily expose the couple to lawsuits. A much more flexible approach to drafting estate planning documents will be required in these “medium-sized” situations.

#### Future of the Estate Tax

##### Current Law

Most readers of this article will remember the “unusual” estate tax law which was passed at Memorial Day of 2001. Under this law, the estate tax exemption gradually rose from its then level of \$675,000, to \$1,000,000 for decedents dying in the years 2002-2003, \$1,500,000 for decedents dying in the years 2004-2005, \$2,000,000 for decedents dying in the years 2006-2008, and, finally, \$3,500,000 for decedents dying in the year 2009. In the year 2010 the estate tax is to be repealed, but then if an individual is “fortunate enough” to survive to the year 2011, he or she will be faced with an estate tax exemption of

only \$1,000,000.

Observing the hurried Senate debates on CSPAN just prior to the 2001 Memorial Day recess, and cognizant of the fact that, beginning in the late 1990s, the Democrats began floating the idea of a \$3.5 million estate tax exemption, it became obvious that the bill which was ultimately passed by Congress just prior to Memorial Day of 2001 favored the Democrats in the Senate much more than it did the Republicans. The Democrats achieved what they desired, a \$3.5 million estate tax exemption, effective at a time when they hopefully would once again have a Democrat in the White House. If a Democrat were not elected in the fall of 2008, on the other hand, Democrats in the Senate could put forward the threat of a \$1 million exemption in 2011, in order to get what they really wanted - a \$3.5 million estate tax exemption.

### Congress' 2009 Budget Resolution

On June 5, 2008, Congress passed its non-binding budget resolution for the upcoming fiscal year. Under this resolution, both the estate tax exemption and maximum estate tax rate would be frozen at their 2009 levels of \$3.5 million and 45 percent, respectively. Significantly, Democratic Presidential Nominee Senator Obama was present for the Senate vote, and voted in favor of the resolution which was ultimately passed. Also perhaps significantly, Senator Obama also voted in favor of an amendment to the budget resolution which would have pegged the estate tax exemption at \$5 million, and the maximum estate tax rate at only 35 percent. Although in times passed Senator Obama has proclaimed that he would repeal all of President Bush's "tax cuts for the wealthy," and return us to the \$675,000 exemption level and 55 percent top marginal estate tax rate which existed in 2001, more recently he has appeared to back off on this rhetoric, and instead state only that he would freeze the estate tax exemption amount and maximum estate tax rate at the 2009 levels, in order to pay for his health care plan.

### Republican Alternatives

Republicans, of course, continue to foster estate tax proposals which would either repeal the tax completely, or at a minimum raise the exemption to \$5 million. They also are hopeful of a maximum estate tax rate of 15 percent. Of course, it is impossible to predict with any level of certainty how the estate tax situation will eventually flush itself out. Although, based on the foregoing discussion, it appears unlikely we will return to a \$1 million or even a \$2 million exemption, after we reach the year 2009, even this is impossible to predict for sure. By the same token, it is also impossible at this time to predict exactly how high the exemption will rise. Much depends, of course, on who wins the White House in November, as well as who wins the majority of the House and Senate. But again, the answers to these latter questions will still only provide us with a better hint as to what will ultimately be decided by Congress and the President relative to the estate tax, presumably sometime before the tax is set to be temporarily repealed, in 2010.

### Estate Planning for Estates Under \$1 Million

#### Focus on Simplicity

Estate planning for married couples with combined estates under \$1 million (including life insurance, IRAs and retirement benefits) is much simpler today than it was "pre-Bush." The unlikelihood that we will ever return to the \$1 million exemption level will normally make it unnecessary to divide

assets between a husband and wife having a combined estate under \$1 million, in order to achieve two estate tax exemptions. Even under pre-Bush law, the estate tax exemption was scheduled to rise to \$1 million by the year 2006, and neither Senator Obama nor Senator McCain is currently proposing an estate tax exemption, for decedents dying in the year 2009 and following, of less than \$3.5 million.

### Avoiding Unnecessary “Exemption Equivalent” Trusts

The fact that it is very unlikely the federal estate tax exemption will ever drop below \$2 million necessitates that estate planners advise married couple clients having combined estates of less than \$1 million to avoid unnecessarily dividing their assets between them, and combining this step with the establishment of an “exemption equivalent” or “credit shelter” trust effective at the death of the first spouse. As discussed further below, dividing assets which were previously owned by the couple jointly as tenants by the entirety may unnecessarily expose either spouse to lawsuits. Also as discussed further below, unnecessarily establishing exemption equivalent or credit shelter trusts may result in an equally unnecessary loss of income tax basis step-up for the trust’s assets at the surviving spouse’s death. Finally, severing joint tenancies and otherwise dividing assets between married partners unnecessarily may have unintended consequences in the event of a subsequent divorce.

If a couple is nevertheless concerned that the size of their combined estate will eventually exceed the federal estate tax exemption level, their estate planning should entail all of the discussion contained in the next two sections of this article.

### Planning for Estates Between \$1 Million and \$3 Million

#### Planning Should be on a Case-by-Case Basis

Planning for married couples having combined estates between \$1 million and \$3 million will obviously be more complex than planning for married couples with combined estates under \$1 million. Perhaps somewhat surprisingly, however, planning for combined estates between \$1 million and \$3 million will oftentimes now actually be more complex than planning with much larger estates.

The increased complexity in this “middle-value estate” area is caused by two primary forces. First, notwithstanding the non-binding budget resolution which was passed by Congress in early June of 2008, it is impossible to predict with any degree of certainty the near or long-term future of the federal estate tax, except perhaps to say that it appears very unlikely the federal estate tax exemption will fall below the \$2 million level. Second, history demonstrates that the stock market can, at any point in time, involve a rapid run-up, so much so that a combined estate valued at less than \$2 million today could become a combined estate with a value in excess of \$3 million, in less than a year’s time.

Estate planners need at all times to be cognizant of potential future run-ups in the value of the stock market, and their relationship to possible future estate tax exemption levels. For example, assume that a husband and wife have a combined estate of only \$1.5 million today, or less than the current \$2 million estate tax exemption. If this couple adopts the simplified “sweetheart will” approach to estate planning, whereby everything is simply left to the surviving spouse, outright, it may be possible that, by the time of the surviving spouse’s death, his or her estate may have grown to a value which is in excess of the estate tax exemption available at that time. This is so because it is simply impossible at the present time to predict with certainty (1) the estate tax exemption level when the surviving spouse dies, and (2) the future

of the stock market.

Other relevant factors in this case-by-case estate planning process for married couples with \$1 million to \$3 million combined estates will include (1) the couple's age, (2) the couple's future earnings capacity, (3) the couple's approach to investing, e.g., equities versus bonds allocation, and (4) the amount of the exemption applicable to estate or inheritance taxes payable in the applicable state, if any.

#### Use of Joint Revocable Trust Coupled with Disclaimer Trust Provisions

Given the future uncertainty in the size of the federal estate tax exemption, as well as the uncertain future of the stock market, one suggested estate planning course for medium-size estates would be to maintain joint ownership of assets between a husband and wife, and couple this with an estate plan which establishes a "disclaimer trust" for the benefit of the surviving spouse and, if desired, the couple's children. As part of this plan, all life insurance and other assets owned by either spouse separately would be made payable to a joint revocable trust at the death of the spouse, either via life insurance beneficiary designation or via transfer on death ("TOD") or pay on death ("POD") beneficiary designation. Normally IRA and qualified plan benefits would not also be made payable to the revocable trust under this plan, other than possibly as secondary beneficiary for the benefit of the couple's children at the death of the surviving spouse.

Under this "disclaimer trust" approach to solving the uncertain future estate tax exemption and stock market dilemma, the surviving spouse would have up to nine months after the first spouse to die's death to decide what portion, if any, of the joint property survivorship interest, life insurance proceeds and/or TOD or POD beneficiary to disclaim, and the portion so disclaimed would then pass to a disclaimer trust for the benefit of the surviving spouse and, if desired, the couple's children. If properly drafted, the assets of the disclaimer trust would not be includible in the surviving spouse's gross estate for federal estate tax purposes; nor would there be a taxable gift upon executing the disclaimer. Disclaimer trusts thus provide the couple with flexibility to make decisions about anticipated future estate tax exemptions and stock market performance anytime within nine months after the first spouse to die's death.

Care must be taken not to rely solely on the ability to disclaim jointly-owned assets, however, as it is not always possible to disclaim a survivorship interest in an asset, just because it is titled in the names of both spouses as joint tenants with right of survivorship. The IRS takes the position that assets owned in the typical joint bank account (including a certificate of deposit or money market account) or joint brokerage account, wherein either party has a power to withdraw the entire account unilaterally, can only be disclaimed to the extent the person making the disclaimer did not transfer assets or funds to the account. Similar rules do not apply to other types of jointly-owned assets, such as real estate.

#### Focus on Asset Protection

A significant advantage of the joint disclaimer trust approach for married couples with medium-sized estates is that it allows the couples the opportunity to preserve a level of asset protection through owning their assets as tenants by the entirety, coupled with a TOD or POD designation to their joint revocable trust. Tenants by the entirety property may only be attached by joint creditors of both spouses, and not severally by creditors of one spouse only. The protections afforded by the joint disclaimer trust approach are not available when assets must be divided between two spouses, as in the case of larger estates discussed below.

### Disadvantages of Disclaimer Trusts

Although the above-described disclaimer trust approach provides maximum flexibility to deal with an uncertain future estate tax exemption and an uncertain future stock market, and helps insulate assets from lawsuits, the estate planner must be mindful that the disclaimer approach also carries with it potential disadvantages, among which are the following:

1. Disclaimers of survivorship interests in jointly-owned property cause probate of the disclaimed interest at the first spouse to die's death.
2. The surviving spouse may not be given the power, either as trustee or via a power of appointment, to appoint trust asset to children or other descendants. Any such power must be exercised by a co-trustee or person other than the surviving spouse.
3. The disclaimer approach relies on future voluntary action by a surviving spouse which may end up not taking place.
4. If assets are disclaimed by the surviving spouse and as a consequence pass to a disclaimer trust, the assets of the disclaimer trust will not receive an income tax basis step-up at the surviving spouse's death, thus potentially causing the couple's children to incur added capital gains taxes after the couple's death. As discussed more fully below in connection with estate tax exemption trusts generally, however, this problem is minimized if the disclaimer trust is properly drafted.

Before advising a surviving spouse to execute a disclaimer, the estate planner must therefore be cognizant of the above potential disadvantages, and only recommend the disclaimer to the extent there is a reasonable likelihood it could result in significant estate tax savings at the surviving spouse's death.

### Alternative Use of Exemption-Type Trust in Certain Situations

If a significant portion of the couple's taxable estate consists of life insurance proceeds or other assets owned by the spouses separately rather than as joint tenants, an approach which may be preferable to the disclaimer trust approach is to provide in the joint revocable trust document that any life insurance proceeds and other assets payable to the revocable trust as a result of the death of the first spouse, pass to an exemption-type trust for the surviving spouse and children. The benefit of this approach is that the first three of the above-outlined disadvantages of the disclaimer trust approach are avoided. And similar to the disclaimer trust approach, the fourth disadvantage may be minimized if the exemption trust is properly drafted, as discussed more fully below.

### Estate Planning for Estates Over \$3 Million

#### Importance of Equalizing Estates

For larger estates in excess of \$3 million, the question for the second half of 2008 and leading into 2009 is how to plan in light of the alternative estate tax scenarios outlined at the outset of this article. With

one important exception discussed below relating to the choice of primary beneficiary for IRAs and qualified plan benefits, this answer is actually easier for large estates than it is for medium-sized estates. Until we have a definitive resolution to the estate tax exemption and maximum estate tax rate situation (which answer will likely not come until late in 2009), estate planners will be wise to assume that, except in community property states, it will still be necessary to divide large estates between a husband and wife in some fashion which will take advantage of each of their separate estate tax exemptions.

### Planning for IRAs and Qualified Plan Benefits

The planning difficulty for large estates will be in deciding how to handle IRAs and other forms of qualified retirement plan assets. Although it is possible to designate an individual's revocable trust as beneficiary of his or her IRA or qualified plan proceeds after his or her death, doing so will mean that, even if the trust instrument is properly drafted, the benefits must be paid out over the life expectancy of the surviving spouse, as the oldest beneficiary of the revocable trust.

On the other hand, designating the surviving spouse as outright beneficiary of the IRA or qualified plan benefits, in order to achieve the maximum "stretch-out" of the benefits for federal and state income tax purposes, is not always the wisest choice either, especially if doing so may mean larger estate taxes at the surviving spouse's death. Before making a blanket decision to always pay IRAs or other qualified plan benefits outright to a surviving spouse, consideration needs to be given to a host of different factors, such as the surviving spouse's age and whether or not this is a second marriage which includes children from either or both spouses.

The older a potential surviving spouse becomes (especially if he or she has already attained age 70-1/2), obviously the less important income tax deferral becomes. And if there is a second marriage involved, with children of either or both spouses, designating the surviving spouse as the outright beneficiary of the IRA or qualified plan has obvious disadvantages.

A final and perhaps most overlooked factor in determining whether an outright distribution of the IRA or qualified plan to the surviving spouse should be made, notwithstanding the potential for increased estate taxes which may result, is the practical question of whether the surviving spouse is even in a position to defer taking withdrawals from the IRA or plan to the maximum extent permitted under the tax law. Often estate planners routinely advise that the IRA or plan benefits should be paid outright to the surviving spouse, in order to take advantage of the spousal rollover rules, without even asking the question what, if any, portion of the proceeds the surviving spouse will require to live on the rest of his or her life. If the question is asked of the clients and the response is that it is likely funds from the IRA or qualified plan will be required by the surviving spouse prior to attaining age 70-1/2, creating the maximum possible stretch-out opportunity becomes meaningless. If this is the situation in a particular estate, and the estate is large enough to merit a division of assets between the two spouses, then the estate planner should not hesitate to pay all or part of the IRA or plan benefits to a revocable trust as primary beneficiary, in order to fully fund the first spouse to die's estate tax exemption.

Of course, if, after dividing the assets other than the IRA and qualified plan benefits between the two spouses, the value of the surviving spouse's estate will likely be substantially lower than the estate tax exemption amount at his or her death, then it may not be necessary to pay the IRA or plan benefits to the first spouse to die's revocable trust as primary beneficiary.

### Avoiding High Income Tax Rates on Exemption and Disclaimer Trusts

A significant problem associated with trusts designed to hold assets equal in value to the federal estate tax exemption, as well as trusts designed to hold assets disclaimed by a surviving spouse, is that certain items of trust income are taxed at the maximum income tax bracket at levels as low as approximately \$10,000 of income. Today these income items include ordinary interest, annuity payments and payments under IRAs or qualified plans, but in the future these income items could include dividends.

It would be a simple manner to avoid the high trust rates on ordinary income by simply distributing all of the ordinary income of the exemption or disclaimer trust to the surviving spouse. This simplistic approach negates the principal purpose of the exemption or disclaimer trust, however, by adding to the value of the surviving spouse's taxable estate.

The preferred approach to solving the high trust income tax problem is to grant the surviving spouse the sole power to withdraw any items of trust income otherwise taxed to the trust at the maximum bracket. As long as the trust agreement is properly drafted,<sup>1</sup> the surviving spouse may have this power, without adverse estate or gift tax consequences, and the income of the trust which would otherwise have been taxed at the maximum bracket will instead be taxed to the surviving spouse. Taxing the surviving spouse on the trust income, without requiring him or her to actually withdraw the same, preserves the primary estate tax minimizing purpose of the exemption or disclaimer trust.

### Terminating Exemption and Disclaimer Trusts Early

Because of the uncertain future of the federal estate tax, exemption and disclaimer trusts must each be drafted to include an "escape hatch" to allow for termination of the trust and distribution of the trust principal to the surviving spouse, in the event the estate tax is either repealed or modified down the road to include an exemption level which comfortably exceeds the value of the surviving spouse's assets, including the assets in the exemption or disclaimer trust. Again as long as the trust document is properly drafted,<sup>2</sup> these escape hatch clauses will preserve the ability to achieve a stepped-up income tax basis on the trust assets at the surviving spouse's death, in appropriate cases, since basis step-up is not available for assets held inside of the exemption or disclaimer trust at the death of the surviving spouse.

### Asset Protection Issues and Use of Domestic Asset Protection Trusts

Dividing assets between spouses which were previously owned by them in tenancy by the entirety form, in order to take maximum advantage of the upcoming \$3.5 million estate tax exemption, carries with it the disadvantage of exposing the divided assets to lawsuits. Strategies to minimize this exposure include minimizing the value of the divided assets in the hands of the spouse in the higher-risk profession, and instead funding his or her share with asset-protected IRAs, qualified plan benefits, or life insurance proceeds (all subject to limits), or using one or more of the forms of domestic asset protection trusts currently available in several states.<sup>3</sup> If the domestic asset protection approach is considered, however, the planner needs to be aware that an argument exists under the recently-amended federal bankruptcy code that a 10-year waiting period applies to transfers to such trusts.

## Estate Planning for Second Marriages

The larger projected federal estate tax exemption makes it easier to do estate planning for second marriages which include children of either or both spouses. This is because the larger exemption makes it possible for each of the spouses, if survived by the other spouse, to leave a larger portion of his or her estate to the children of the previous marriage, without incurring estate taxes.

If a second marriage couple instead prefers to leave the bulk of their assets in trust for the benefit of the surviving spouse, with remainder at the surviving spouse's death to the first spouse to die's children, the larger projected federal estate tax exemption may actually make it possible to leave the assets in a QTIP Trust, rather than in a more conventional exemption trust, in order to achieve a stepped-up income tax basis for the first spouse to die's children, at the death of the surviving spouse.

## Charitable Tax Planning

In the past, most charitable bequests generated a charitable estate tax deduction benefit to the decedent's estate, thus saving the beneficiaries of the estate as much as 55 cents for each dollar the decedent left to charity. With the projected larger estate tax exemption, however, most bequests to charity will no longer generate an estate tax benefit to the decedent's family.

In appropriate situations, it may thus now be advisable for the couple to leave the amount they wish to eventually go to charity, to the couple's children, with the expression of the couple's "desire" that their children in turn donate the same to charities designated by their parents. As long as the couple is confident their children will carry out their wishes, this technique will have the benefit of generating income tax deductions to the couple's children after the couple's death, without reducing the amount which the charities receive. Similar rules obviously also apply to unmarried clients.

## Conclusion

It is incumbent on estate planners that they prepare new estate plans for married couples and, where necessary, revise existing plans, to account for the uncertain status of the federal estate tax exemption. Unnecessary "exemption equivalent" or "credit shelter" trusts, which at best will have the effect of causing unnecessary capital gain taxes to the next generation, should be eliminated, and necessary exemption equivalent, credit shelter and disclaimer trusts should be modified to minimize income taxes.

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<sup>1</sup> See Blase, "Recent Tax Acts Require Focus on Income Tax Aspects of Estate Planning," 30 Estate Planning 617, at 619-622 (December 2003).

<sup>2</sup> *Id.* at 618-619.

<sup>3</sup> See, e.g., Blase, "The Missouri Asset Protection Trust," 61 Journal of the Missouri Bar 72 (March-April 2005).