BY MICHAEL B. ALLMON, CPA; MICHAEL DiBERNARDO, CPA & BRYCE FALCON, CPA

Certain Uncertainty

Avoiding Traps for the Unwary

In recent years, the estate tax has become increasingly enigmatic. Taxpayers and planners alike often find ourselves consulting extemporaneous sources such as newspaper headlines or crystal balls in futile attempts to predict the upcoming iteration of estate tax law. With such uncertainty on the horizon, the question becomes how one may even begin to approach modern estate planning. For this answer, it may be helpful to start with a brief history of the estate tax.

Historical Context

The estate tax began with a stamp tax in 1797, which was then repealed in 1802. This tax did not return until the Civil War. In was reinstated in 1864, then repealed again at the end of that war. The modern estate tax system really began in 1898 to raise revenue for the Spanish-American War, but also was repealed at the end of that war in 1902. The estate tax that we have today was established by the Revenue Act of 1916. It expired in 2010, but retroactively was reinstated, and it was made permanent in 2012.

Since 2012, there have been several attempts to change our federal estate, gift and generation-skipping transfer tax exemptions. These recent attempts by Congress remind us that even permanent taxes are subject to change, and that estate related taxes are likely the most political taxes in the modern United States' system of taxation.

The Politics of Taxes

Why are transfer taxes considered to be such an extremely political tax? For two primary reasons:

1. The amount of revenue derived is not significant to the U.S. budget (income and Social Security taxes on individuals account for more than 66 percent, consumption, property and corporate taxes contribute about 34 percent, with the estate and gift tax revenues at less than one-half of 1 percent of receipts and one-tenth of 1 percent of GDP, per the Congressional Budget Office as reported in their most recent report from 2020); and
2. The number of citizens who are subject to these taxes is small (about two out of every 1,000 citizens were even subject to the estate tax at all according to the Joint Committee on Taxation of the US Congress in 2015, the most recent year that data is available for, and even fewer today with the significantly higher exemption levels). Further the only taxpayers who are subject to these taxes are those who are ultra-wealthy (taxable estates more than over $12 million this year if unmarried and potentially $24 million for married couples). Thus, they are "easy targets" for raising revenue (their political influence does not arise from their number, but from their ability to obtain influence by their financial strengths, including campaign contributions). In 2020, only 1,275 estates paid any estate tax according to IRS.

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Changes in the Wind

In 2021 we saw four proposed tax laws (American Families Plan, The 99.5 Percent Act, The Infrastructure Investment and Jobs Act and Build Back Better bill) that, if enacted, would have overhauled our transfer tax system. Because of the political sensitivity of these taxes, there were no significant enacted changes to our transfer tax system.

Whether overhauls of our system of taxation occur or not, the estate tax related laws (commonly called "transfer taxes") are scheduled to change by statute in the next few years regardless of such attempts to change now. For this reason, it's important to have flexibility in estate planning documents so they may be effective despite changes to our tax laws.

It's also key to build flexibility into the beneficiary designations for defined contribution plans, life insurance, etc. as part of the estate plans. Income tax law changes have changed recently to require the total amount of a defined contribution plan to be withdrawn over 10 years in many situations. Additionally, significant wealth is held in such plans (especially defined contribution plans), and the question to address is whether the amounts left to beneficiaries should have controls (in these situations a trust as beneficiary could be advisable for non-tax reasons).

Because of ever-changing lifetime exemptions, it's strongly recommended that all CPAs consider filing an estate tax return upon the first death of a married couple, even where the estate is not large enough to require that filing, for the purpose of making a "portability" election. Even if a married couple has a traditional "A, B, C" type estate plan (which creates at least one new trust for the

deceased spouse upon their death), it's usually advisable to make this election to transfer their unused exemption to their spouse.

Even without continuing attacks on the current exemption levels, the exemption is scheduled to change by law. Existing tax laws call for the current $12 million+ exemption to drop to $5 million (as adjusted for inflation, so probably about $6 million, or about half of what it is today) in 2025.

Trust Protector

Since uncertainty is the certainty, the key to modern estate planning is flexibility. Flexibility must now be drafted into all documents that carry out future wishes. Further, systematic review of estate plans is now more important than ever. CPAs can assist in this by keeping copies of client's estate plans so that we know when they were reviewed and can then recommend that they be reviewed when we see changes in our clients' situations or in tax laws (and probably at least every five years in any case).

One concept that can create flexibility would be the use of a trust protector (see "CPAs as Trust Protectors," *Journal of Accountancy*, March, 2007). A trust protector can have the power to change trust documents to serve the client's wishes. These powers can be defined to include trust changes when the tax laws change, and the trust is accidentally not changed to reflect those changes. Flexibility also might be needed if a beneficiary's situation changes (if a beneficiary experiences a lawsuit or divorce, for example—or if a beneficiary becomes a "special needs situation"—a protector might have the power over distributions to minimize risks from such situations).

The powers that a protector can be given are limited only by the imagination and the creativity of the drafting attorney. The American Bar Association lists the most common powers as:

- Arbitrate disputes between trustees and beneficiaries or between beneficiaries;
- Modify the trust agreement for purposes of correcting mistakes and taking advantage of tax laws;
- Construe terms of the trust and advise the trustee and beneficiary of the same;
- Alter a beneficiary's interest in the trust;
- Terminate a trust;
- Remove and replace trustees;
- Add or remove beneficiaries to a trust;
- Interpret the rights of a beneficiary to accountings and other trust information;
- Grant, modify or revoke a beneficiary's power of appointment;
- Change the distribution standard; and
- Approve trust accountings and trustee compensation.

A trust protector can also assist in decisions regarding pension type distributions (including IRAs, life insurance, etc.), assuming that the trust has been designated as the beneficiary that follows the spouse (so that the trust receives distributions at the second death).

Current law would likely require the defined contribution plan amounts to be fully distributed within ten years of death all at ordinary income tax rates (and without the benefit of a "step-up" in basis). It is possible that this shortened distribution period might change, in which case the protector might want to change the distribution provisions (if given that ability) to spread out the distributions. Under current law, the protector might want to be sure that the distributions are spread over the 10 years, especially if the amounts to be distributed are significant.

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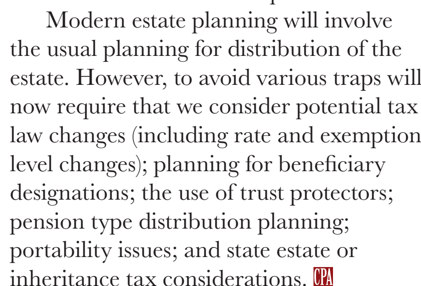
The protector might also be involved in analyzing the advisability of taking defined contribution plan assets out during the lifetimes of the couple who earned them. In the case of a taxable estate, the income taxes paid then effectively become deductible against the estate tax (because they have reduced the estate by the end of the couple's lives.) If distributed after death, they could be subject to estate tax, Federal income tax and state income tax (potentially more than a 90 percent overall effective tax rate).

A protector might be used if a beneficiary is subject to claims of a creditor or soon to be ex-spouse. Given appropriate powers the protector may be able to stop distributions so that a court cannot allow them to be subject to claims. This is obviously a subject for the attorneys involved in this planning.

Conclusion

Too often we see clients living in states with state-level estate taxes telling us that they are not subject to estate taxes because they are unaware that states can have differing (and lower) exemption levels (for example, an individual with a $7 million estate living in the state of Washington would owe about $700,000 in state estate tax, in spite of having no federal tax obligation—and no state income taxes). Estate tax planning should be alive and well in such states! About 12 states have estate taxes. Be sure that you know the estate tax laws of the state that your client lives in and that those taxes are planned for.

Modern estate planning will involve the usual planning for distribution of the estate. However, to avoid various traps will now require that we consider potential tax law changes (including rate and exemption level changes); planning for beneficiary designations; the use of trust protectors; pension type distribution planning; portability issues; and state estate or inheritance tax considerations. CPA



Michael B. Allmon, CPA, MBT, **Michael DiBernardo**, CPA and **Bryce Falcon**, CPA, MBT, are from Allmon, DiBernardo & Associates CPAs & Wealth Strategists, LLP. They can be reached at mikea@mbamdcpas.com, miked@mbamdcpas.com and bryce@mbamdcpas.com

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AUG. 10

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AUG. 18

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