Lowenstein Sandler's Trusts & Estates Podcast: Splitting Heirs

Episode 6 -
The Renoir Spelling Bee

By Warren Racusin, Tracy Snow, Richard Schmalbeck
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Warren Racusin: We once represented a senior executive at a big pharmaceutical company. When he died, he left three children at a pretty sizable estate. We did all the usual things you've learned about in previous podcasts. We gathered up and valued his assets. We paid the debts at expenses and we prepared the estate tax returns. His son, who was the executor, really nice guy, signed the returns. We filed them with the IRS and the state, and we patted ourselves on the back for a job well done.

A few days after we filed the return, I get a call from the son, the executor. He says, "There are a few assets that I didn't tell you about when we prepared the estate tax return." Now we've heard that one before. And so sort of half listening I said, Oh really?" He says, "There are a few pieces of art." I say, "Oh really?" He says, "Yes. One of them is a Renoir." Now I, as well as the client signed the return. And filing a false return, is as we tell our clients, a felony punishable by fine and imprisonment. So now I'm really listening. And I say, "What?" And the executor, really nice guy says, "Yes, Renoir, R-E-N-O." I stop him in the middle and I say, "I know how to spell it"

From the law firm, Lowenstein Sandler, this is Splitting Heirs. I'm Warren Racusin.

Music: (singing)

Warren Racusin: Today, we're going to take on a challenge posed to us by one of our loyal followers. He said that he really likes the podcast, but the tax stuff, that wasn't the exact word he used, though it did start with the letter S. He said, "The tax stuff bores me. No way to make it dynamic and exciting." Our job today is to prove that listener wrong. Helping us lead the charge, my colleague, Tracy Snow, a lawyer here at Lowenstein who councils clients on estate tax planning, and Richard Schmalbeck, professor of law at Duke University Law School and formerly Dean of the University of Illinois College of Law. Rich has written and lectured extensively on federal tax policy. Tracy is going to take us through the what and the how much of the state taxes.

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Rich is going to help us understand the why. Why is there an estate tax, or as some fondly put it, a death tax?

So when we're done, you may still not be so happy about the tax, but at least you'll understand how it works and why it exists in the first place. And just for full disclosure, we're going to talk about the federal estate tax. A number of estates had their own estate or inheritance taxes, and you need to consult with your tax advisors about those additional state level taxes as well. Tracy, let's start with the bad news. The federal estate tax is an expensive tax. It's a flat 40% tax on the value of everything you own, right?

Tracy Snow: Yes. And it's everything, Warren. Your home, your investment accounts, your retirement plans, your insurance, things that you might traditionally think of as non probate assets that don't even pass under the well. Everything that you have an ownership interest in is caught up in this web that we call the federal estate tax.

Warren Racusin: Right. So when you say everything, you mean everything, which leads me to the, be sure to look in the attic rule, that one of my mentors taught me. The executor's job, as we know, is to make sure all of the assets of the estate tax have been identified, gathered up. The be sure to look in the attic rule has its origins in an estate of a person who lived in a modest house, in a modest neighborhood, in a modest town. The executor went through the whole house. And then just to be thorough, climbed into the dust, filled attic, found a shoebox, opened it and found 15 million words of stock certificates in it.

Tracy Snow: And on the opposite end of the spectrum, there's those cases where you can hire someone to go in and appraise the things that are in the home. They go into the house of someone who's died, they look at the walls and then they see a blank wall with a paint color that's very different than the rest of the walls around it. Think maybe someone took a painting off the wall before they got there?

Warren Racusin: And to make things worse, Tracy, the tax is due nine months after date of death, right?

Tracy Snow: Yeah. And it's really a long period of time, especially when you have a grieving family who has just buried a loved one. They have to write a check to our friends at the IRS nine months after their loved one has died. And when I say a check, I really do mean you're literally writing and FedExing a check. You could have a lot of liquid assets that are generating this tax, a business, a home, real estate, cryptos, whatever. But you might not have the liquid assets, the cash to pay it. And you could try offering that Renoir you talked about, but the government doesn't care. They might say nice picture, but you owe us eight million, where is our $8 million in cash. And you don't want to be put in a situation where you have to sell things at a fire sale, just so you can raise the cash to pay the tax.

Warren Racusin: A little bit today and more in future podcasts, we're going to talk about how to deal with that liquidity issue. But you're right, it's not a pretty picture, no pun intended.

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Tracy Snow: Yeah. So now the better part, I get to talk about the good news, not so much the bad news. There are some things you can do even on this simple estate 101 level.

Warren Racusin: Right. Although I guess there's not really any good news about talking about a tax that happens after somebody dies, but it's all relative, I suppose.

Tracy Snow: Yeah. It's part of life and death. So the first thing that's pretty simple, it's the marital deduction. And that's just fancy talk for saying that if you have spouses to married individuals, they can leave any amount of assets to each other without paying any federal estate tax. So you could have a $100 million in your estate and have a simple one line will that says, "I leave everything to my spouse and there's not going to be a dime of estate tax that is paid there." But I do want to make a disclaimer. We do not recommend that you create a one line will for various other reasons, of course. But the marital deduction is as simple as that.

Also, when I say married, Warren, I really mean married. One of the key court cases that moved the needle towards recognizing same sex marriage was actually a federal estate tax case. And when this landmark case came out, I was so proud because I thought here, we have trust in estates making history. It was called US v. Windsor. A woman died, leaving everything to her female spouse. They had actually gotten married in Canada where same sex marriage was legal and they had moved to New York where it was recognized. The IRS wouldn't allow the marital deduction and they actually had generated an estate tax of $363,000. It got to the Supreme Court and the court ruled that the IRS had to allow the marital deduction because the deceased woman and her spouse were legally married. And for estate tax purposes, married means married.

Warren Racusin: Right. So basically the government makes a deal with a married couple. The IRS says, "We won't tax you so long as one of you is alive and the first to go leaves everything to the survivor. But at the death of the survivor, we're going to come knocking on your family's door and hit you with an estate tax on the surviving spouse's assets, including everything the surviving spouse got from the first to die spouse." Right?

Tracy Snow: Yeah. But here's where the second piece of good news comes in. It's called the unified credit. Sometimes it's called the estate tax exemption. Each person has an exemption. They can leave a certain amount of assets to anyone, not just us a spouse, in any form, without any estate tax. It's a get out of jail free card for the estate tax. The amount changes each year with cost of living adjustments for 2022, the amount is $12,060,000.

Warren Racusin: So if our pharma exec had died in 2022 and the Renoir plus her other assets didn't exceed $12,060,000, there wouldn't have been any federal estate tax on it anyway. Right?

Tracy Snow: Exactly. And here's the other cool thing about the estate tax exemption. The spouse who dies first can leave her unused estate exemption to her spouse as well as leaving her assets to him. It's called portability. So the survivor can leave up to approximately 25 million to heirs without any estate tax.

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Warren Racusin: What do you mean by unused estate tax exemption, Tracy?

Tracy Snow: Well, the exemption, we say it's a unified credit. It's unified because it covers gifts made during lifetime as well as the assets of your estate. So for example, if you make $5 million of lifetime taxable gifts, you have about seven million of exemption left at your or death to protect your estate assets.

Warren Racusin: So regardless of what you may think about the collective intelligence of the United States Congress, they were smart enough to figure out that if there's a big estate tax, but you can give away assets during lifetime, without any tax at all, everyone will do just that. They'll give the assets away just before they die. So if you make gifts during lifetime that are more than $12 million, you'll pay a gift tax when you make those gifts.

Tracy Snow: Right. And it's not like the $75, like on the Monopoly board, it's a flat 40% tax, just like the estate tax.

Warren Racusin: Seems pretty simple, right? Give everything to your spouse, give them your unused exemption and your kids or your family members, whoever you want, eventually get the first 25 million free of federal estate tax. Right?

Tracy Snow: Yeah. It's simple, a sound way to do it, but we're not sure that's always the best way, depending on the situation. Because if the survivor's assets grow during his or her lifetime, after the first spouse death, all that growth is then going to get hit by the estate tax when the survivor dies.

Warren Racusin: Is there a better way to do it?

Tracy Snow: There can be, and this is one of the simple techniques that we often employed. It's something called a credit shelter trust. So instead of the first spouse giving away or porting their unused estate tax exemption to the surviving spouse, the spouse who died can actually use up that exemption by creating a trust, called a credit shelter trust, at their death. So if they have $12 million of exemption remaining at their death, they can give in their will, that $12 million to a credit shelter trust. And that trust would be for the surviving spouse's benefit. And you can add in other beneficiaries of the trust as well, such as kids. It's called a credit shelter trust because it does exactly that, it shelters your exemption or your unified credit from estate tax. And then when the surviving spouse dies, any balance remaining in the trust can pass to the kids or anyone else free of estate tax. The cool thing about it is, not only as the original $12 million pass estate tax free, but any appreciation or growth on those original assets also passes free of estate tax.

Warren Racusin: Boiler alert here. When we get to the more advanced seminar in estate planning and estate tax avoidance podcast, actually won't be that advanced, don't get too nervous, we're going to get in some other really interesting ways that you can help save estate tax, but we want to just keep to the basics here. Rich, so we've got a lot of questions for you. For one, why is there an estate tax in the first place?

Richard Schmalbeck: It's justified, I think, by several different arguments. One is that it does add a bit of progressivity to the overall system. Progressivity is generally the idea

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that the more ability to pay tax you have, not only more dollars you should pay, but the higher proportion of your resources should be devoted to tax. That's what makes a progressive system. Over the history of our country, at least the history of our income tax over the last 110 years or so, Congress has generally endorsed the idea which must reflect the American people's idea that a mildly progressive tax system is desirable. And the estate tax is one of the most progressive elements, because as I say, it just only impacts people of quite high wealth.

Warren Racusin: So in other words, the more you have, the more you should have to pay because the more you can afford, in a nutshell.

Richard Schmalbeck: Exactly. Another argument is that it does operate at least mildly to impede dynastic wealth creation. If each generation can pass free of any tax, the full value of a very wealthy person's estate, they have a lot of economic advantages, in any event. They can afford expensive colleges and make substantial investments in the human capital of their offspring. An unimpeded wealth transfer system would make that a little worse.

Also, one of the worst rules in our tax system, I think is the one that'll allows heirs to take a fair market value at the date of death basis in any property that they inherit from a decedent. Now, what that means is, especially in the context of today's third industrial revolution or whatever you want to call it with the tech age, there are an awful lot of tech billionaires out there who have founder stock in Microsoft or Intel or any other of the more recent wealth creating, Apple, any of those firms. Most of that wealth has not been taxed at all. It is not taxed under the income tax of the founder because there's no realization of it. There's no sale or other disposition of the assets. So the income tax doesn't reach it at the level of the mogul who created the wealth. And if they pass it on to heirs, it won't be taxed either because they get to sort of skip over the gain part and start again with assets that have bases equal to their fair market value so that there's no gain to be had.

Warren Racusin: So if you have an asset that's gone way up in value, you never pay income tax on that until you sell the asset. And if the mogul doesn't sell the asset and then dies without an estate tax, that growth in value, that growth and wealth, never gets taxed at all, right?

Richard Schmalbeck: That's right. So taxing unrealized depreciation, it's really something the income tax ought to do. We have to get rid of that stepped up basis rule. But as long as we still have it, the estate tax is a backstop on a function that the income tax is performing in our system.

And finally, the estate tax undoubtedly stimulates charitable giving. In fact, in recent years, gifts made by decedents is approximately equal to the amount of tax paid. Now, of course, you don't know what the gift amount would've been if there were no estate tax, but that there have been some studies that do suggest that there is a responsiveness on the part of decedents, while they were live, while they were doing their estate planning, that definitely operates to the benefit of charities.

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Warren Racusin: So when you leave assets and your will to a charity, you don't have to pay estate tax on that to try to, again, as you said, sort of encourage people to be charitable. They can give it to the IRS, or they can give it to their favorite charity. And a lot of people would prefer to go that other route, right?

Richard Schmalbeck: Absolutely.

Warren Racusin: Right.

Richard Schmalbeck: And the charitable deduction is unlimited.

Warren Racusin: Unlimited. It's unlike the income tax charitable deduction, which has a variety of limitations on it. You get a dollar for dollar deduction off of your estate taxes, for anything that you leave to charity, 100%. But as you know, the estate tax has become an emotional issue as well as a dollars and cents issue. Again, as I said before, it's sometimes referred to as the death tax. But you've written about this and there are arguments to be made against the estate tax. You want to take us through some of those?

Richard Schmalbeck: Well, first, I'd like to point out that the death tax is really a misnomer. As others have pointed out, death is neither a necessary nor a sufficient cause for a wealth transfer tax. We do have a gift tax and obviously, that's one that be imposed without the death of the donor. And of course, most deaths do not result in any federal estate tax. We are, at this point, with the inflated exemption level from the 2017 Tax Act, which roughly doubled that amount temporarily, are only reaching about one tenth of 1% of decedent estates. So the death does not cause a death tax 99.9% of the time, at least at the federal level.

Warren Racusin: And in those situations where an estate tax return gets filed, not even all of those pay an estate tax itself. Sometimes it could be that you're filing an estate tax just to show that you left everything to your spouse, as Tracy said, no tax on that, you just have to file the return. So even with the small number of estate tax returns that get filed, many of them don't actually pay an estate tax, right?

Richard Schmalbeck: That's right. It's only a little more than half of the estate tax returns that are filed that are taxable estates.

Warren Racusin: Right. But leaving that aside, there are philosophical arguments, let's call them, against the estate tax. You laid out the arguments in favor. Take us through some of the arguments that people who don't like the estate tax so much point to.

Richard Schmalbeck: One of the ones that you hear almost invariably among opponents of the estate tax is that it's a double tax. The theory being that the decedent was taxed when he or she earned the income in the first place, now they've saved it and they're going to tax it again when they pass it to the next generation. I'd point out, first of all, that often it's not true through that there's a double tax. We just talked about the unrealized depreciation that never gets taxed in the decedents income tax return. And so the estate tax is only a single tax in that event. But it's also true that really, the number of times something gets taxed

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is somewhat irrelevant. What you really ought to be interested in is the total tax burden.

There are lots of situations, just as an example, you buy an expensive automobile, pay a sales tax on it. You might, if you live in one of those states, as I do, that has a personal property tax, you'll pay an annual tax on the holding of that car. You pay gasoline and tire taxes as you use that car. And when you need repair and maintenance of the car, you'll pay a sales tax on the services that are provided with respect to that car. So there's nothing that unusual about multiple opportunities that various governments take to tax something. So that's simply not a valid objection.

Another argument that you hear is that it's a largely avoidable tax. In hearings before Congress in 1975, James Casner, who was a Harvard trust and estate law professor said, "It's really a voluntary tax. You pay it if you want to and you don't have to pay it if you don't want to." That has a narrow kind of technical truth to it because of course, with an unlimited charitable and an unlimited marital deduction, as long as you don't leave anything to anybody that isn't a charitable organization or your spouse, you can indeed avoid the tax no matter how large your state is. But, if you want to move substantial wealth down to the next generation, which is what most people do want to do, you can do various things, and I know your firm is expert in the various things that are available.

Warren Racusin: Flattery will get you nowhere professor.

Richard Schmalbeck: You have to reduce that tax bite. But nevertheless, there is usually tax bite if you are moving substantial sums to the next generation. And the whole idea, if this were a voluntary tax, why would high wealth individuals who can afford expensive advice volunteer to pay it? And yet they do. Estate tax collects now in the vicinity of $20 billion a year. It could be a much more potent revenue generator if we wanted it to be. So in the year 2001, just before some of the first major estate tax cuts went into effect, we were collecting over $30 billion of tax, and on an inflation adjusted basis, that's more like 50 billion. So we know how to design an estate tax system that can collect relatively easily, 50 billion a year. And at that rate again, it sort of belies the idea that it's a voluntary tax because we don't observe people volunteering to pay tax. And it also suggests that if there may be more revenue significance to the tax than a lot of people think that there is.

Warren Racusin: $20 billion in a budget or an economy as large as ours may be a relative drop in the bucket. Although I haven't looked at the numbers recently, $20 billion probably would fund say the Department of Homeland Security or something close to it. So as they used to say, a billion here and a billion there, pretty soon, you're talking about real money. So $20 billion is nothing to sneeze at.

Richard Schmalbeck: And as I say, it could be more if we wanted it to be. We just have to lower the exemption to a level where you weren't allowed to pass 24 million to the next generation without any tax bite.

Warren Racusin: Right. And one of the pieces of bad news that Tracy kept away from you is that while the exemption now is just over $12 million, come 2026, the law

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says that exemption will essentially get cut in half to $5 million plus cost of living, which would leave it now just over $6 million. So we'll see what happens, but it could be a more meaningful tax down the road.

But if I'm hearing you right, professor, what you're really saying Rich, is that there's been an awful lot of attention paid to income inequality and wealth inequality in this country and the adverse, or bad things that can happen in a society where there's great inequalities of wealth and income, the estate tax you're saying is or could be a way to try to chip into that inequality a little bit and make things a little bit fair. I'm not taking a position for or against that. And any clients listening, trust us, regardless of what our philosophical views are, we will try to squeeze that tax dollar as tight as we possibly can for your benefit. But it's the idea that the estate tax could make things a little bit less unequal.

Richard Schmalbeck: Right. And of course, it's a delicate judgment. You would like to reduce inequality to some degree. On the other hand, you certainly wouldn't want anything that came very close to looking like a confiscatory tax at death. People who have worked hard all their lives deserve to be able to benefit their next generation and the generation after that, if they want, without an unduly heavy tax burden. The 40% rate strikes me as about right. If we had maybe a less generous exemption, we might be able to get by with a 30 or a 35% rate, and there people who would probably prefer or that. I wouldn't pose that if it came in connection with a reduction in the exemption. But the idea is you take a little bit of a bite and you use that to meet the revenue needs of the country that would otherwise have to be met by some other kind of tax that would be less progressive.

Warren Racusin: Well, hopefully this discussion has, as I said, enlightened everybody a little bit about how the tax works, how much it is, why there's a tax and maybe even stimulate some additional thought in everybody's part. I certainly hope that I have, or we have, proved our loyal listener wrong, and that you make this stuff interesting.

Music: (singing)

Warren Racusin: Thank you, Professor Richard Schmalbeck. Thank you, Tracy. Thanks to everybody here at Lowenstein and Good2bSocial who makes these podcasts possible. Mostly, thank to all of you for listening. We'll see again next time. Until then, as we say in these parts, have a good one.

Music: (singing)

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