SMOLENPLEVY
EST. 1977

Report From Counsel

Insights and Developments in the Law **Winter/Spring 2015**

Is the "Step Up" Stepping Down?

A Potential Change in How Inheritances are Taxed

When President Obama delivered his State of the Union Address last month, no doubt every estate planning attorney in the country sat up and took notice when he proposed ending the "step up" provision in the capital gains tax. If Congress agrees (a big "if"), it could mean sweeping changes in how inheritances are taxed—and how estate attorneys help their clients deal with that.

The President's proposal would eliminate a significant tax benefit in the treatment of inheritances. The plan would tax capital gains on the decedent's basis, instead of the current system that allows a step up in basis for assets passed on to heirs. The change, if enacted, would have wide-ranging effects on many families—making it much harder to shield assets from taxes. To do so would require a great deal more planning and a lot of help from estate planning attorneys and accountants.

Jason Smolen

Trust Fund Loophole

The President says that his proposal closes what he calls "the trust fund loophole" and will ensure that the wealthiest Americans pay their fair share on inherited assets. But, in

Continued on page four.

Accolades for SmolenPlevy

U.S. News & World Report and Best Lawyers has ranked SmolenPlevy as a first-tier Washington, D.C. law firm in its annual "Best Law Firms" publication. Firms included in "Best Law Firms" are recognized for professional excellence with consistently impressive ratings from clients and peers. Receiving a tier designation reflects the high level of respect a firm has earned among other leading lawyers and clients for their abilities, professionalism and integrity.

Principal Daniel Ruttenberg is "AV Preeminent" rated by Martindale-Hubbell, confirming that his legal abilities and professional ethics meet the very highest standard. Joining Co-founding Principals Alan Plevy and Jason Smolen, Ruttenberg received the highest rating given by Martindale-Hubbell.

Principal Kyung (Kathryn) Dickerson and Associate Gretchyn Meinken are recognized as members of Virginia's Legal Elite by Virginia Business magazine for 2014. In cooperation with the Virginia Bar Association, Virginia Business surveyed lawyers throughout the state to nominate the best in their profession. Dickerson and Meinken were selected in the categories of family law and Young Lawyers, respectively.

FIFTH FLOOR • 8045 LEESBURG PIKE • VIENNA, VIRGINIA 22182
TELEPHONE: 703.790.1900 • FAX: 703.790.1754
SMOLENPLEVY.COM

Arbitration Clauses in Employment Contracts

The Federal Arbitration Act requires courts to enforce clauses in commercial contracts that require arbitration of disputes. The U.S. Supreme Court has ruled that transportation workers engaged in interstate commerce are exempt from the Act. For other types of workers, the effect of the Supreme Court ruling was to reaffirm the enforceability of mandatory arbitration provisions in agreements entered into by workers engaged in interstate commerce.

Interstate Commerce Requirement

The Act's requirement that workers be engaged in interstate commerce is not especially difficult to meet, given the interconnectedness of the economy. When a nurse at a hospital tried to avoid binding arbitration of her wrongful discharge claim by arguing that her employment agreement had no impact on interstate commerce, the argument failed. The court pointed out that the nurse's employment depended on the constant use of supplies purchased from other states and that the hospital treated many out-of-state patients. More often than not, similar connections can be made between most jobs and the flow of interstate commerce, especially for large employers.

Level Playing Field

To say that employers and employees generally may bind themselves to arbitration is not to say that there is no judicial oversight. In the time since the Supreme Court cleared the way for mandatory arbitration, courts have been occupied with creating a level playing field when employers make the signing of an arbitration agreement a condition of employment. If its terms weigh too heavily in favor of the employer, the agreement, or at least the offending part, may be ruled invalid.

Finding that an arbitration agreement was "utterly lacking in the rudiments of evenhandedness," one federal court refused to enforce an agreement that allowed only the employer to choose the panel from which an arbitrator would be selected. Supposedly the parties were to achieve a fair result by using an alternate strike method to arrive at one arbitrator, but, given that the whole pool was selected by the employer with no constraints, "an impartial decisionmaker would be a surprising result." It may be possible to avoid this particular defect by stating in the agreement that the parties will use an arbitration service that takes measures to find an unbiased arbitrator having no potential conflicts of interest.

Paying the Costs

Splitting the costs of arbitration evenly between the parties may seem reasonable on its face, but some courts have invalidated such clauses as being too burdensome for individual employees. Aside from considering the respective abilities of the parties to pay what can sometimes be substantial upfront costs for arbitration, there is a concern that the prospect of shouldering those costs has a "chilling effect" on employees' rights to have their grievances heard. Alternative approaches include payment of all costs by the employer, waiver of the employee's share on a case-by-case basis if it is beyond the employee's means, or capping an employee's share at the level of costs that would be incurred in court.

To Arbitrate or Not?

Even before an arbitration clause is agreed to, and perhaps later scrutinized by a court, the parties need to consider some distinctions between mandatory arbitration and litigation. Since it is easier to request arbitration than to file a formal complaint in court, use of arbitration may mean an increase in disputes to be resolved. A decisionmaker in arbitration, if he or she is familiar with the industry in question, could understand complex issues better than a jury would. In arbitration, the dispute itself and the terms of any award frequently are kept confidential, affording the parties more privacy than a trial in open court. Finally, some of the same features that make arbitration a simpler and more streamlined approach, like limited factfinding and having no right to appeal, could weigh in one party's favor and against the other, depending on the circumstances of the case.

Employment Law Guidebook

The U.S. Department of Labor publishes a guidebook to provide businesses with general information on the laws and regulations that the Department enforces. The guidebook describes the statutes most commonly applicable to businesses and explains how to obtain assistance from the Department for complying with them.

The authority of the Department of Labor extends to many statutes, but the following are several that affect most employers: Employee Retirement Income Security Act (ERISA); Occupational Safety and Health Act (OSHA); Fair Labor Standards Act (FLSA); and Family and Medical Leave Act (FMLA).

The *Employment Law Guide: Laws, Regulations and Technical Assistance Services* can be accessed at www.dol.gov/compliance/guide.

Life Insurance Can Be Part of Your Estate Plan

Even if you have a relatively modest estate, life insurance can be an important aspect of estate planning for the obvious reason that it can substantially increase the value of your estate. Where the death of a person is premature and a young family is in need of support, life insurance may be the primary means for the family's financial survival.

Even in larger estates, life insurance can be useful by providing the liquidity necessary to pay estate taxes and expenses without the necessity of selling off assets that a family would prefer to keep intact. Additionally, life insurance, unlike many other assets, does not have to go through a time-consuming administrative process before it becomes available to beneficiaries. Therefore, life insurance can be an immediate source of funds for a surviving family.

Estate Taxes and Life Insurance

As is true of any aspect of estate planning, one objective is to minimize the federal estate tax effect that life insurance can have. The primary tax issue that arises is whether the insurance proceeds are included in the estate for federal estate tax purposes. Including the proceeds could generate additional estate tax liability and reduce the amount of the proceeds that are available to the decedent's heirs.

The fundamental rule is that the gross estate will include the value of life insurance proceeds if (1) the proceeds are payable to the decedent's estate and are thus receivable by the executor, or (2) the proceeds are payable to other beneficiaries, but the decedent possessed at his or her death any of the "incidents of ownership" with respect to any policy.

The term "incidents of ownership" is defined more broadly than to be limited to the legal ownership of the policy. The term includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy or pledge it for a loan, and to obtain a loan from the insurer against the surrender value of the policy. There are other indirect ways that the decedent can be found to possess incidents of ownership. For instance, if the decedent is the controlling shareholder of a corporation that possesses an incident of ownership, such possession is attributed to the decedent.

Life insurance can be useful by providing the liquidity necessary to pay estate taxes and expenses without the necessity of selling off assets that a family would prefer to keep intact.

Another scenario that will result in the inclusion of life insurance proceeds in the decedent's estate arises under certain circumstances where the decedent was the initial owner of the policy but transferred such ownership to another person or entity within three years of his or her death. Thus, even where the decedent has rid himself or herself of all incidents of ownership in the policy, there is still the possibility of inclusion under this three-year rule.

Keeping Life Insurance Proceeds Out of Your Estate

A common device for handling the life insurance aspect of an estate plan is the life insurance trust. Typically, a person would initiate the life insurance coverage by acquiring the policy. He or she would then transfer all incidents of ownership of the policy to a previously created irrevocable trust, which would be the named beneficiary on the policy. Assuming that the person survived until at least one day more than three years after the transfer of the policy to the trust, there would be no inclusion of the proceeds in the settlor's estate. If a policy is transferred within three years of death, the proceeds are included in the estate.

If the trust itself acquired the policy, the person would never be the owner and the three-year rule would not apply. The problem would be that the person could neither direct nor require the trust's acquisition of the policy without risking the possibility that he or she would be regarded as the original owner of the policy for purposes of applying the three-year rule. Therefore, it is important that the trustee be completely independent of the decedent.

An insurance trust can also have the practical effect of serving as a means of coordinating the collection, investment, and distribution of the proceeds of several policies. An insurance trust can hold other assets that the decedent transferred to it during his or her life. The trust can also receive assets "poured over" to it by the decedent's will.

If life insurance is to be an element of your estate plan, it should be carefully integrated with the other aspects of the plan. Be sure to seek the guidance of a qualified professional to assist you.

"Step Up"

Continued from page one.

reality, this term is a misnomer (in fact, it would result in more assets being funneled to trusts—but more on that later). And the proposal would impact more than just the rich. To put it simply, it's essentially a brand new tax on inheritances that would take money out of the pockets of beneficiaries and result in a host of unintended consequences. For example, heirs would need to determine the original cost basis of all assets they inherit. Think about that. That means every share of stock, every piece of property and every valuable would need to be traced back to the original cost. That would be a nightmare.

Current Step Up Rules

But before we get into the details about what the proposal would mean, let's look at an example of how the current "step up" rules work. Say your client bought shares of GE stock 15 years ago for $500. At the time of his death, that stock is worth $2,500. That represents a gain of $2,000 that your client has paid no taxes on. If your client had left those shares of GE stock to one of his children, his child's cost basis would be $2,500. That means that whenever his child sells the stock, she'll only owe tax on capital gains that accrue over the $2,500 cost basis. However, under President Obama's proposal, any capital gains, if not exempt, over the original $500 he paid would be taxed.

Investment Assets

The President's plan does allow married couples to bequeath investment assets with capital gains up to $200,000 tax-free. Further, a couple can bequeath a home to a child, and $500,000 in capital gains wouldn't be taxed. (The amount that can pass without tax is half for individuals.) However, even with these exemptions, the elimination of the "step up" can put a large financial burden on some heirs. Though the proposal isn't clear on how the tax would be implemented, the bill may be due on the death of the parents, reducing what transfers to the children and potentially putting a significant economic burden on a transferred business. This impacts estates and families that may have far fewer assets than the current federal estate exemption of $5.43 million, because it significantly broadens the tax base and the type of tax applied.

Unintended Consequences

As for eliminating what the President refers to as "trust fund loophole"? In reality, trusts would actually expand. Without the "step up" provision, many beneficiaries would need to set up trusts to protect their assets from the increased taxes. It's no surprise that, in this scenario, trusts become much more appealing. A donor can transfer assets to the trust. This way, when he dies, his death wouldn't be a taxable event.

The end of the "step up" could also affect your client's other big life decisions. With the estate exemption currently at $5.43 million, planning what to keep or gift to minimize capital gains taxes is a large part of the conversation. Since most estates will never be as large as the exemption, it's the capital gains tax that will come into play. Your client can sell and pay the tax while he's alive; or, if his appreciated assets exceed $200,000 ($500,000 for a home), he can have it taxed on his death. As a result, the biggest unintended consequence of the president's proposal is that elimination of the "step up" provision could negatively impact heirs who don't necessarily fall into the "rich" category.

First, your client doesn't have to be "rich" to have assets above the exemption if he lives in an area where houses cost so much, and second, congratulations, your client's estate will be taxable even if he doesn't have assets in excess of $5.43 million.

SmolenPlevy in the Media and in the Community

Alan Plevy

The holidays are a time for family, which may make it hard on children of divorced parents. Co-founding Principal Alan Plevy shared tips for handling the holidays on NBC Washington. Principal Kyung (Kathryn) Dickerson joined him on *Let's Talk Live* and was featured on WNEW radio offering suggestions.

Kyung (Kathryn) Dickerson

There's a chill during the winter not just outside but in many marriages. Dickerson explained why January is a busy time for divorce on WNEW radio.

The proposal to end the "step up" provision in the capital gains tax could mean changes in how inheritances are taxed. Co-founding Principal Jason Smolen took an in-depth look at the proposal in Wealth Management and MainStreet.

Principal Scott Taylor attended A Wider Circle's 2014 Community Gala. A Wider Circle aims to end poverty by offering long-term support for struggling individuals and families.

Associate Gretchyn Meinken spearheaded the Junior League of Northern Virginia's "Share the Warmth" campaign, which collects coats for local children.