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FEBRUARY 2009

TAX & ESTATES DEPARTMENT

ALERT

NECESSITY FOR REVIEW OF ESTATE PLANS BECAUSE OF FEDERAL ESTATE TAX LAW CHANGES

PROBLEMS AND OPPORTUNITIES

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In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) made significant changes to the federal estate and related gift tax law. The maximum federal estate tax rate was lowered from 55 to 45 percent and the amount of assets exempt from the federal estate tax was increased.

By way of background, each person can leave as much as he or she wants to a spouse, either outright or in a trust for the exclusive benefit of the spouse, without incurring a federal estate tax (the Marital Deduction). Assets that qualify for the Marital Deduction on the first death are taxed at the second death. However, assets left to a *non-spouse* are exempt from the federal estate tax only to the extent of an available statutory exemption from that tax (the Exemption). Accordingly, most estate planning aims to maximize use of the Exemption. EGTRRA provided for significant increases in the Exemption as follows:

Year	Increased Exemption
2002 and 2003	1,000,000
2004 and 2005	1,500,000
2006, 2007 and 2008	2,000,000
2009	3,500,000

In 2010, the estate tax is fully repealed. It is restored in 2011 with an Exemption of $1,000,000. At the same time, the maximum estate tax rate goes back up to 55 percent. Given the current economic and tax climate, it has become increasingly likely that permanent repeal will not be allowed to happen. At present, it seems likely that the Exemption of $3,500,000 and the estate tax rate of 45 percent will be frozen at those levels. Congress is now considering how to deal with EGTRRA.

Proper Planning to Use Increased Exemption

Because of the increased Exemption, with proper planning, at present a married couple is able to pass as much as $7,000,000 to the next generation free of estate tax. However, full use of the Exemption from each spouse is not automatic. Under current law, there are two basic steps necessary to make certain that the Exemption allowable to each spouse is fully used regardless of the order of deaths.

First, each spouse must have estate planning documents that allow for maximum use of each Exemption. A plan that leaves all assets outright to the surviving spouse will waste an Exemption and generate a higher federal estate tax than is necessary, leaving less for children. The usual way to avoid this negative tax result is for both spouses to have estate planning documents that, on the first death, leave assets equal to the Exemption either (i) to a trust for the benefit of the surviving spouse in what is known as a "credit shelter" or "bypass" trust, rather than outright, or (ii) directly to children (outright or in a trust). If done properly, the assets covered by the Exemption of the first spouse to die (and all appreciation on that amount during the surviving spouse's lifetime) ultimately passes to children free of estate tax.

Second, in order to actually obtain the tax benefit from an Exemption, each spouse, individually, must hold assets with a value at least equal to the amount of Exemption intended to be used.

- Because of the increased Exemption, asset realignments may be necessary to accomplish this result. Also, the recent decline in the equity markets may, for example, have altered a prior planned asset alignment. The property must be held or structured in a way that it passes under the Will or Will substitute (i.e., a revocable trust) of the first spouse to die rather than directly to the surviving spouse. Neither jointly-owned assets nor life insurance or other benefits payable directly to the surviving spouse will count in this regard.
- The nature of the assets may prevent spouses from accomplishing the goal of dividing assets. For example, one spouse may have a significant amount of assets in income-tax deferred vehicles such as IRAs or 401(k) plans (Qualified Plans) so that ownership cannot be moved into the other spouse's name. With the increasing popularity of Qualified Plans, many people have a significant amount of their assets in such vehicles.
- Also, Qualified Plans are generally poor assets to leave to a "credit shelter" or "bypass" trust because such a disposition may severely limit possible continued income tax deferral, which would otherwise be available if such plans were left directly to the surviving spouse. In some situations, it may be necessary to choose between income tax planning and estate tax planning. Fortunately, there are available *planning techniques* to address this tax dilemma such as flexible beneficiary designations, putting "disclaimer" provisions in beneficiary designations and making a single pool of assets available to fund the Exemption of the first spouse to die regardless of the order of deaths.

Avoiding Unintended Consequences from the Increased Exemption

Due to the increased Exemption, there could be possible unintended consequences from current estate plans, particularly for persons of more modest means.

Couples who have Wills with "formula" clauses designed for tax purposes to pass an amount equal to the Exemption to a "credit shelter" or "bypass" trust for the benefit of the surviving spouse, or even directly to children, may end up with results they did not expect. For example, with such formula clauses, all (or substantially all) of the first spouse's estate may end up in a trust for the surviving spouse, with little or nothing passing directly to the surviving spouse, or may end up passing to children before the death of the surviving spouse. Again, there are planning techniques that can be employed to address these issues.

> **Example:** Consider a couple with a combined net worth of $4,000,000. Given the increased Exemption, it may make sense for this couple to divide ownership of their assets (say $2,000,000 each) and to do Wills that in the first instance leave everything outright to the other, but also give the surviving spouse the choice (by a "disclaimer") to allow all or part of this outright inheritance to pass to a "credit shelter" or "bypass" trust for his or her benefit. This is sometimes called a "Disclaimer Estate Plan." If the surviving spouse disclaims the entire $2,000,000, that amount would not be part of the surviving spouse's estate as it would be in a "credit shelter" or "bypass" trust. Only the remaining $2,000,000 in his or her own name would be potentially taxable for estate tax purposes and the surviving spouse's Exemption ($3,500,000) would be sufficient to eliminate the estate tax exposure on this remaining amount. If the surviving spouse does not elect to disclaim, he or she will have an estate of $4,000,000 subject to Federal estate tax and only a $3,500,000 Exemption to cover it. This subjects $500,000 to tax. The Disclaimer Estate Plan is flexible and allows the surviving spouse to take a look at the asset levels, tax law and prospects for asset appreciation or consumption after the first death and, within nine months from the first death, decide whether a "credit shelter" or "bypass" trust is necessary or desirable for planning purposes.

Another possible unintended result from the increased Exemption may be significantly higher state death taxes at the first death. In fact, many states (such as New Jersey) have a state death tax that goes up significantly as the size of a "credit shelter" or "bypass" trust goes up. Consequently, the increased Exemption may require state death tax planning as well as planning with respect to the estate tax.

Opportunity to Simplify Some Estate Plans

Because of the increased Exemption, couples with more modest means may be able to significantly *simplify* their estate plans by doing away with "credit shelter" or "bypass" trusts altogether and the formula clauses that create them. This is especially true in situations where the combined net worth of both spouses is under $3,500,000 and is not expected to grow to the point where it exceeds such amount.

> **Example:** A couple with a combined net worth of $2,500,000 with no expectation of significant growth in the future could, if they desire, simply leave everything outright to each other with no negative federal estate tax results. The unlimited "marital deduction" would eliminate any estate tax on the first death and the survivor's Exemption ($3,500,000) would eliminate any estate tax at the second death. No trusts are necessary to have this zero tax result.

The increased Exemption, which became effective in 2009 ($3,500,000) and which may, by new legislation, be frozen at that level, presents both estate planning problems and opportunities. Estate plans should be reviewed and, if necessary, revised to address these problems and take advantage of the opportunities.

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If we have represented you in connection with your estate planning, please contact the lawyer with whom you have discussed your situation previously. All of the members of our Tax & Estates Department would be pleased to speak with you. Visit us on the web at www.foxrothschild.com.

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