

MARRIED WITH ASSETS

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For many years the standard protocol for affluent couples has been to draft estate plans designed to minimize estate taxes by putting some of the assets of the first spouse to die into a “credit shelter” or “bypass” trust to shelter the assets from estate taxes down the road.

The New Federal Estate Tax

The estate tax overhaul President Obama signed this past December appears to liberate many affluent couples from dispensing with these sometimes costly, cumbersome trusts (assuming they are in stable first marriages and trust each other to manage their joint wealth). Here’s what such couples need to consider:

Under both the new law and the old one, on the first spouse’s death, you can leave a surviving (US citizen) spouse or a charity an unlimited amount, without worrying about tax. But the new law makes two key changes.

First, it raises each individual’s lifetime exemption from federal estate and gift tax for transfers to nonspouse heirs to a hefty \$5 million, from \$3.5 million in 2009, and only \$2 million in 2008.

Second, it makes the exemption “portable” between spouses- meaning a surviving spouse can add any unused exemption of her just-deceased spouse to her own \$5 million exemption. So a widow or widower can pass on as much as \$10 million, untaxed, through either lifetime gifts or bequests.

Portability Isn’t for Everyone

- a. Portability isn’t Automatic.** To get it, the executor of the estate of the first spouse to die must file an estate tax return, even if no tax is due. Surviving spouses should get this return filed even if they have nowhere near \$5 million of their own, because someday, who knows? Portability also isn’t retroactive, so it’s no help to those who lost spouses before 2011. Finally, it doesn’t apply to the \$5 million per person exemption from “generation skipping” tax - the extra tax imposed on gifts to grandkids whose parents are still alive. That means the truly rich will want to use up their own \$5 million exemptions, likely through gifts in the next two years.
- b. The new estate law and portability expires at the end of 2010.** If Congress doesn’t act before then, not only will portability lapse, but the exemption amount will revert to \$1 million and the estate tax rate will increase to 55% from the current 35%. Estate experts disagree whether this makes it risky to

rely on portability when redoing estate plans. Some believe portability may not continue after 2010, while others believe portability is here to stay.

- c. **State Estate Taxes.** Currently 16 states and the District of Columbia impose estate taxes, and most have exemptions of only \$1 million or less. Minnesota has a \$1 million exemption, and the other states on the estate tax list are Connecticut, Delaware, Hawaii, Maine, Maryland, Massachusetts, Illinois, New Jersey, New York, North Carolina, Ohio, Oregon, Rhode Island, Vermont and Washington State. No state now has portable exemptions.

In these states tax rates can exceed 16%. So a survivor in these states will still want to consider funding a bypass trust up to the state tax exemption amount.

What to do? If you're affected by estate taxes, your current estate plan likely includes a bypass or family trust - a legal approach designed to preserve the estate tax exemption of the first spouse to die, without leaving the survivor short of funds. At the death of the first spouse, an amount goes into a trust for the surviving spouse and then the kids. While the surviving spouse has access to the earnings (and in some cases principal) of the trust, the money isn't hers outright and bypasses her taxable estate when she dies.

Look at your plan; if it funds a bypass trust up to the deceased spouse's federal exemption (as opposed to a set amount), your spouse could be left with nothing outside that trust. That's inconvenient and can result in bad income tax consequences. In such cases you may want to consider changing the wording, or possibly eliminating the trust.

I Disclaim, You Disclaim. Estate lawyers are now touting an idea some used to belittle: disclaimer trusts. You leave everything to your spouse outright, but give her the right to disclaim (turn down) all or part of the inheritance and have it go into a bypass trust, allowing her to make an informed decision based on her finances and the latest federal and state estate tax laws after the first spouse dies.

So what do some estate attorneys have against disclaimer trusts? Disclaimers can be tricky. You can't, for example, disclaim assets you've already touched. But mostly, some estate lawyers haven't trusted surviving spouses to disclaim assets when they should. Now the new game in estate planning is an old-fashioned form of trust - that is trust the surviving spouse to take the right action.