Estate Planning Insights

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THE NEW TAX LAW AND WHAT IT MEANS–PART TWO

In our previous newsletter, we discussed the new tax law that was enacted on December 17, 2010. We noted that the new law is generally favorable to taxpayers. We pointed out, however, that the provisions in the new law will expire on December 31, 2012. Thus, it is somewhat difficult to do estate planning right now, with the future estate tax exemption amount and rates unknown at this time. Nevertheless, there are certain "rules of thumb" to help with current estate planning. Wealthier clients should be taking advantage of the $5 million gift and GST tax exemptions in effect for 2011 and 2012. No one should be relying on portability yet.

Estate Planning Considerations. For persons who die in 2011 and 2012, the exemption from the federal estate tax (or, death tax) is $5 million. For persons who die *after* 2012 (i.e., nearly all of you reading this newsletter), the law on the books provides that the estate tax exemption amount will be (only) $1 million. That's a big difference. Another big difference is the estate tax rate. The estate tax rate for persons who die in 2011 and 2012 is 35%, while the estate tax rate for persons who die after 2012 (per the law on the books) ranges from 41% to 55%, and even 60% in some cases (most people use an average rate of 50% for quick calculations).

Will Congress change the law before 2013? Many nationally known estate planning experts say "Yes," primarily on the theory that we've never had a decrease in the estate tax exemption amount once we reached a certain level. While that may be true, the new emphasis on reducing the federal deficit and the need for tax reform may weigh against that assumption. In the meantime, how can we do estate planning when we don't know the future exemption amount or tax rate? Before we answer that question, we need to remind everyone how the estate tax worked before *portability* was added to the law in the recent tax act. (Later, we will compare portability to traditional bypass trust planning.)

Bypass Trust Doubles A Couple's Exemption From The Estate Tax. Under "standard" estate tax law (i.e., the law *before 2011* and *after 2012*--unless Congress changes it), married couples do not automatically receive 2 exemptions from the federal estate tax. Unless a married couple creates a "Bypass Trust" (also called a "Credit Shelter Trust") on the death of the first spouse (or uses other techniques utilizing the first spouse's exemption), only 1 estate tax exemption is available to shelter the couple's combined assets from federal estate tax on the death of the surviving spouse. Thus, when the estate tax exemption amount was $1 million (as it was in 2002 and 2003, and as it could well be after 2012), a married couple with a total net worth of $2 million who did not create a Bypass Trust to hold the $1 million estate of the first spouse to die had to pay $435,000 in estate taxes on the second spouse's death (the $435,000 amount is the actual tax amount, rather than $500,000, which is the rough amount when using the 50% average tax rate for a "quick and dirty" calculation).

Contrast the result above with the result in the case of two unmarried persons, each having a $1 million estate, who happen to die at the same time as each spouse in the case above. In the case of each single person, no estate tax would have been payable on the transfer of their respective estates at death due to utilizing their respective $1 million exemption amounts. Why this difference for married couples? Call it a "marriage penalty at death," if you will. The result is actually due to "overuse" of the federal estate tax marital deduction. Stated another way, the result is due to *insufficient (estate) tax planning*.

Marital Deduction Only Defers Estate Tax. If the surviving spouse is a US citizen, assets owned by the first spouse to die passing directly to the surviving spouse will qualify for the federal estate tax marital deduction, eliminating current estate tax on the assets transferred by the deceased spouse to the surviving spouse. However, after that transfer, the surviving spouse would then own 100% of the assets and would only get to use 1 estate tax exemption with respect to the transfer of all of the assets at his/her death because the surviving spouse is just 1 individual. Thus, while the marital deduction *defers* estate tax until the death of the surviving spouse, it doesn't eliminate estate tax. On the other hand, effective use of the estate tax exemption amount, such as funding a Bypass Trust on the first spouse's death, will eliminate estate tax on that amount (plus growth on that amount after the first spouse's death), assuming the assets are still held in the Bypass Trust when the second spouse dies.

Here is an *oversimplified* example of the above:

Facts: Married couple with a $2 million Community Property ("CP") Estate, both US citizens, estate tax exemption of $1 million, and no portability

$2,000,000 CP
/ \
$1,000,000 $1,000,000
Husband's half Wife's half

Case #1: No Bypass Trust

Husband dies 1st. Per simple Will (*and/or* JTWROS or beneficiary designation in favor of wife), all of husband's $1,000,000 estate passes to wife, free of estate tax on husband's death (due to the estate tax marital deduction). *Wife now owns a $2,000,000 estate.*

Wife dies 2nd, leaving her entire estate to the couple's children. Here is the (simplified) tax calculation on wife's death:

Wife's Estate:	$2,000,000
Wife's estate tax exemption amount	($1,000,000)
Wife's taxable estate	$1,000,000
Estate tax on taxable estate	$435,000
Net to children	$1,565,000

Case #2: Husband's Will Creates Bypass Trust

Husband dies 1st. All of husband's $1,000,000 estate passes into a Bypass Trust pursuant to his Will, with wife as Trustee and primary beneficiary of the Trust for her life (children and grandchildren are optional secondary beneficiaries of Bypass Trust during wife's life). Distributions can be made to wife (and children and grandchildren) from Trust for purposes of health, support, maintenance and education, to maintain accustomed standard of living. On wife's death, all of the assets in the Bypass Trust are distributed directly to the children, free of estate taxes in wife's estate. Wife's personally owned estate also passes to the children, free of estate taxes. Here is the tax calculation on wife's death:

Wife's Estate:	$1,000,000
Wife's estate tax exemption amount	($1,000,000)
Wife's taxable estate	$0
Estate tax on taxable estate	$0
Net to children	$2,000,000*

*Children receive wife's entire estate and all assets in Bypass Trust at time of wife's death. Note that the Bypass Trust assets could be worth more than $1,000,000 at time of wife's death if assets experienced any appreciation in value after husband's death and/or if income earned by the Trust assets was retained in the Trust (net after-tax income is added to the principal of the Trust).

Enter Portability. The recent tax act added something we have never had before: portability of exemptions between spouses. For married persons *who die during 2011 and 2012*, if certain actions are taken and certain "bad actions" are avoided, it may not be necessary to create a Bypass Trust on the first spouse's death to obtain 2 exemptions per couple. However, portability expires on December 31, 2012, unless Congress passes a new law to continue it.

How does portability work under current law? Suppose the husband and wife have a combined estate of $10 million, all community property, meaning that each spouse has a $5 million estate. Assume the husband dies first, leaving everything he owns directly to his wife. There is no estate tax on that transfer due to the marital deduction (this is the same result as before portability). ***If*** the husband dies in 2011 or 2012, and ***if*** the Executor of the husband's estate timely files a U.S. Estate Tax Return ("Form 706"), and ***if*** the Executor elects portability, then the husband's $5 million estate tax exemption amount is transferred to the wife. ***If*** the wife then also dies before December 31, 2012 and ***if*** the wife does not remarry prior to her death, the wife will have $10 million in total estate tax exemption to eliminate estate tax on the couple's combined $10 million estate passing on the wife's death. PLEASE NOTE ALL OF THE ***IFS*** ABOVE.

What are the problems with portability? First, both spouses must die in 2011 and 2012 under current law to insure the use of portability. Second, the Executor of the first spouse's estate must file a federal estate tax return to elect portability, regardless of the size of the first spouse's estate. Preparing a Form 706 is not an inexpensive undertaking (the cost of doing that usually exceeds the cost of including a Bypass Trust in a Will, although funding a Bypass Trust adds costs, too). Third, if the surviving spouse remarries, the deceased spouse's estate tax exemption that was "ported" to the surviving spouse can be lost if the surviving spouse's new spouse dies before he/she does, with insufficient or no unused estate tax exemption, because only the most recently deceased spouse's unused exemption amount can be "ported."

Our view is that, under current rules, portability is more of a remedial measure than a planning tool. We just don't have any assurance that it will continue after 2012 (although some people are betting that it will). In our opinion, based on current law, it is always better for couples with more than a $1 million combined estate to have some type of Bypass Trust provision in their Wills, rather than merely having "simple Wills" and hoping that

portability will be available to eliminate estate taxes on the second spouse's death. However, if a couple has simple Wills and one spouse dies this year or next and the couple's combined net worth exceeds $1 million, then the portability option may "save the day" in terms of avoiding *unnecessary* estate taxes on the death of the surviving spouse (meaning, estate taxes that could have been avoided had the first spouse to die not *wasted* his/her exemption from the estate tax by leaving everything directly to the surviving spouse).

Bypass Trust Versus Portability. For couples with a combined estate exceeding $1 million, in almost every respect, a Bypass Trust is superior to not having a Bypass Trust and using portability to avoid future estate taxes. The one exception is the income tax basis differential, which will be discussed below.

Advantages of Bypass Trust over Simple Will + Portability (assuming same ultimate estate tax result):

1. Protection of the trust assets from creditors' claims.
2. Protection of the trust assets from being diverted to the new spouse (or "special friend") of the surviving spouse (some of my clients call this "bimbo protection"–note that a *bimbo* can be male or female).
3. Enables professional management of the trust assets.
4. Provides a "ready-made" asset management device in the event the surviving spouse loses his/her mental capacity (whether the successor Trustee is a professional Trustee or a trusted family member or friend).
5. Serves as a "tax shelter" to the extent of any increase in the value of the trust assets during the life of the surviving spouse due to capital appreciation and/or the accumulation of net after-tax income in the trust (i.e., there is no estate tax on this post-death growth).
6. Provides more income tax options (because the surviving spouse is not the only possible taxpayer–the other beneficiaries of the trust and/or the trust itself can pay income tax on trust income, depending on the treatment of the income).
7. Avoids the need to file a U.S. Estate Tax Return (Form 706) for the deceased spouse's estate if the value is less than the exemption amount.
8. Preserves (doesn't waste) the deceased spouse's estate tax exemption amount, no matter what (without a trust, the first spouse's exemption could be lost if the surviving spouse remarries or if portability "sunsets").
9. Can allocate GST exemption (if applicable).

Advantages of Simple Will + Portability (assuming same ultimate estate tax result):

1. Simplicity.
2. No loss of second step-up in basis on death of surviving spouse.

Income Tax Basis Matters. When the first spouse dies, all of his/her separate property (if any) and both halves of the community property receive a new basis for federal income tax purposes equal to the fair market value of the assets on the deceased spouse's date of death. Because of the type of estate planning usually done, and in view of the fact that, for most married couples, all of the assets are community property, this often produces a "tax-free step-up in basis" for all of the couple's assets on the death of the first spouse. (Of course, a "step-down" in basis can also occur if the assets have declined in value from their original basis, as was often the case during the recent recession.) Thus, due to the step-up in basis to fair market value on the date of the first spouse's death, if the surviving spouse were to sell any of the assets after that time, the capital gain or loss would be determined by subtracting from the sales price the new (presumably higher) basis received as a result of the death of the first spouse (and not the original basis when the asset was first acquired).

When assets pass from the deceased spouse into a Bypass Trust, the assets have already achieved a step-up in basis to the fair market value on the deceased spouse's date of death. If those same assets are still held in the Bypass Trust on the surviving spouse's death, because they won't be included (and taxed) in the surviving spouse's estate for federal estate tax purposes, they won't be achieving a second step-up in basis on the surviving spouse's death. When the applicable estate tax rate is 55% (or more) and the long-term capital gains tax rate is only 15% or 20%, this loss of the second step-up in basis is usually more than offset by the estate tax savings. On the other hand, the current estate tax rate is only 35% and the current long-term capital gains tax rate is only 15%. Thus, as the differential between the two rates declines (and as the estate tax exemption amount increases), this loss of the second step-up in basis is more problematic. There are some techniques that can be used to avoid this loss, but they are beyond the scope of this newsletter.

Bottom Line. All married couples with combined estates greater than $1 million should have some kind of Bypass Trust provision in their Wills. Right now, couples with a combined estate between $1 million and $5 million are using Wills that give the surviving spouse the *option* to create a Bypass Trust on the death of the first spouse. These Wills are sometimes called "Disclaimer Wills" because that is the mechanism used to exercise the option. The beauty of this estate plan is that, if the estate tax exemption amount does return to $1 million due to inaction by Congress, or if Congress reduces the current $5 million exemption to a lower amount, a Bypass Trust can always be created by the surviving spouse by exercising the option in the deceased spouse's Will. On the other hand, if the couple's combined estate at the time

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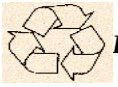

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of the first spouse's death is less than the estate tax exemption amount, the surviving spouse can do nothing and all of the assets will pass directly to her. The surviving spouse can then decide whether to elect portability by having the Executor of the deceased spouse's estate file a federal estate tax return.

Remember that, if no Bypass Trust is created and portability is not available (for whatever reason: expiration of the portability provisions, failure to file a Form 706 for the first spouse's estate, remarriage of the surviving spouse with the new spouse predeceasing and having little or no available exemption), the couple's combined estate (both halves of the community property, plus any separate property) must be less than 1 exemption amount (not 2 exemptions) or there WILL be estate taxes on the surviving spouse's death. The goal is for the surviving spouse to personally own assets having a total value less than 1 exemption amount (whatever that amount happens to be). Also, remember that, the most that can be placed in a Bypass Trust is the deceased spouse's half of the community property, plus his separate property, if any. Except in the case of a non pro rata distribution, the surviving spouse's assets cannot be placed in the Bypass Trust because that will make the Trust includable and taxable in the surviving spouse's estate for federal estate tax purposes. Couples with a combined net worth of more than $5 million (and couples in a second marriage) should generally be using a "formula" or "mandated" Bypass Trust. Couples with more than $30-$50 million in assets should be affirmatively using all or part of their $5 million lifetime gift tax and GST exemptions in "leveraged" transactions designed to reduce future estate taxes (unless they wish to leave most of their estate to charity–another way to avoid future estate taxes).

Continued Discussion of New Law? We may continue this discussion in a "Part Three" newsletter, although it may not be next time (we have many other important issues we would like to discuss also). Stay tuned!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above. You can also reach us by email addressed to:

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