THE COUNTS LAW FIRM, LLC

Finally, Some Certainty for the Estate Tax… at Least for Two Years

As you may recall from our last Client Alert (*What Estate Tax? ~ April 21, 2010*), the only thing that was certain about the federal estate tax was that we had anything but certainty. It was anyone's guess what Congress might do. We never expected the estate tax to be repealed, but when December 31, 2009, came and went, and then more months passed with no Congressional action, we settled into the idea that repeal was here to stay for taxpayer deaths occurring in 2010.

Christmas came early for estate planners around the country when Congress enacted the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (the "2010 Act"), and the President signed it into law on December 17, 2010. The compromise bill that we heard so much about in the news relating to the extension of the so-called "Bush Tax Cuts" also included new estate tax provisions. The details of the new estate tax law are as follows:

1. For deaths occurring in 2010, an estate can choose between (1) no estate tax and carryover basis for income tax purposes or (2) an estate tax with a $5 million exemption amount and step-up in basis for income tax purposes.
2. For deaths occurring in 2011 and 2012, the estate tax is reinstated with a $5 million exemption amount and a 35% tax rate. "Portability" of estate tax exemption is available for married couples, which allows a surviving spouse to claim a deceased spouse's unused exemption amount.
3. The new law expires at the end of 2012. If Congress fails to enact extenders or revisions, the estate tax exemption will return to $1 million at a 55% rate in 2013, and portability will no longer be available to surviving spouses.

Since the signing of the 2010 Act, estate planners and tax advisors have been busy analyzing the new law to determine how it will affect clients and their plans going forward. There are mixed feelings on the new concept of portability. It was intended to make marital estate tax planning easier by allowing spouses to use two times the exemption amount (or $10 million) without the need for credit shelter trusts. You may recall that prior to 2010, a married couple who left all of their assets outright to each other in their estate plans wasted the estate tax exemption of the first spouse to die. Credit shelter trusts were used to shelter the estate tax exemption of the first spouse to die, so that at the time of the second spouse's death, up to two times the exemption amount would pass tax free to children or other beneficiaries. At first blush, portability should prevent married couples from being punished for failing to obtain good tax and estate planning advice. Credit shelter trusts (and the legal fees to set them up) are not necessarily needed any longer to use both spouses' exemptions. However, upon a closer inspection of portability, it does not eliminate the need for the many other benefits a credit shelter trust can offer, and thus, the benefits of sound legal advice.

Let's look at a simple example. Joe and Mary have assets worth $7 million, and all are titled jointly. Joe dies first and everything passes to his wife. Because of the unlimited marital deduction, Joe doesn't have to use any of his estate tax exemption, meaning he has left $5 million of unused estate tax exemption for his surviving spouse. Upon Mary's subsequent

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death, she has her own $5 million exemption and $5 million of her deceased husband's unused exemption, for a total of $10 million in potential estate tax exemption. Her assets are still worth $7 million, and so she has plenty of exemption to pass all of the assets estate tax free to their children.

Now let's add a few real life plot twists to our example. After Joe's death, Mary later re-marries Edward. Because it is a second marriage and both spouses have children of their own, they agree to keep all of their assets titled separately. After ten years of marriage, Edward dies. He had assets totaling $5 million of his own, and he left all of his assets to his children. So where does that leave Mary? Well, she is only allowed to use the unused exemption of her *most recently deceased spouse*. Edward, not Joe, is her most recently deceased spouse, and he didn't leave any unused exemption. Thus, Mary has only her own $5 million exemption to use at her death, but she has $7 million of assets. The $5 million of Joe's unused exemption is lost.

Let's add one more real life plot twist. Mary is a savvy investor, and she manages to turn her $7 million of assets into $9 million by the time of her death. Not only does she have just $5 million of exemption available to her, her assets have appreciated since her first husband's death, and this leaves a taxable estate of $4 million. Applying the 35% tax rate results in an estate tax of $1.4 million. Mary's children are upset because that $1.4 million tax bill could have been avoided.

If Mary and Joe had used traditional credit shelter trusts, they wouldn't have wasted Joe's $5 million estate tax exemption. Further, they could have also removed some or all of the $2 million appreciation from Mary's taxable estate by funding a credit shelter trust with the assets that were most likely to appreciate. These are just two reasons why most planners think that credit shelter planning is still an essential tool for certain clients. Other benefits include the ability to protect the assets in a credit shelter trust from the surviving spouse's creditors and spending habits. Further, a credit shelter trust will allow the deceased spouse to control the disposition of the assets at the surviving spouse's death – a potentially important feature for clients who have children from prior marriages. Finally, at this point, portability is only available for deaths occurring in 2011 and 2012. We have no idea if it will be an available for surviving spouses in future years, meaning the original reason for using credit shelter trusts may return. Another drawback to portability is that a timely estate tax return must be filed (even if not otherwise required) to claim the deceased spouse's unused exemption.

So what is the bottom line for YOU?

Some of you may be thinking to yourself, "Heather, my net worth, plus life insurance, is well under $5 million, so I'm good, right?" Not so fast. The $5 million estate tax exemption was enacted for deaths occurring in 2011 and 2012. If Congress doesn't act again, the estate tax exemption goes back to $1 million in 2013, and the tax rate goes back to 55%.

So where does that leave us? In the estate planning community, we sometimes like to speculate about what Congress may or may not do. We should have learned our lesson when

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we all speculated that surely the 2010 repeal would never actually happen. Despite being burned in the past, I will share some of what I hear from estate planning prognosticators. One point being made is that while Congress may not let the exemption return to $1 million, they could lower it back to 2009 levels ($3.5 million). Further, in this political climate where the fiscal hawks have the stage, it isn't impossible to think that the exemption may be reduced – whether to $1 million, $3.5 million or some other number – as a way to generate a little more revenue for the feds. It leaves us with few options but to plan for the law we have now, try to build in as much flexibility as we can, and then adjust as time passes and the laws inevitably change again.

So – back to that bottom line. Total up the value of all of your assets, including the assets of your spouse if you are married. Remember to include your retirement accounts and the death benefit on all life insurance policies that you own. If that total is:

1. Less than $1 million: No need to worry about estate taxes at this time, but depending on when you first completed your estate plan, it may be a good time to review things.

2. More than $1 million but less than $5 million: You may have an estate tax issue in 2013 depending on what Congress does – or better put, doesn't do. Please contact me to discuss your estate plan and the options available to you. (More important, please contact me to review your existing plan. You may already have credit shelter planning in your documents, and you may, or may not, need it.)

3. More than $5 million: You likely already have estate tax planning in your documents (or you should!), but they may need to be adjusted to take into account the significant increase in the exemption, and also the new concept of portability. Please contact me to discuss your estate plan and the options available to you.

For all of my existing clients, I'm happy to schedule a complimentary one hour conference to review your existing estate plan and determine the best approach for you in light of the 2010 Act. Please remember what I likely told you in our first meeting – plan to review your estate plan every 3 to 5 years, or sooner if there are significant changes in your life or the law. Folks, this qualifies as a significant change in the law.

I look forward to hearing from you with your questions and comments, and as always, it is my pleasure to be of service to my clients.

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