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Saving Estate Taxes!

Estate Planning and the Estate Tax Marital Deduction

This article is a review and reminder of the reasons for and benefits of Marital Deduction planning. This means using a **Family Trust and Marital Trust** within a Will or Revocable Living Trust. Many of our clients have used this planning for tax savings, asset protection and legacy planning.

Although you can leave everything you own to your spouse free of estate tax, doing so can actually increase estate tax costs at your spouse's death. The reason for this is that each person upon death can pass on \$3.5 million of assets to children or other non-spouse beneficiaries without any federal estate tax liability. However by leaving everything outright to your spouse, you waste your **federal estate tax exemption**.

Now the State of Maine has its own estate tax. If a deceased person's estate is over \$1 million, the estate will owe estate tax.

Coordinating the tax breaks in both spouse's estates is a cornerstone of successful estate planning. As an example, looking only at the federal estate tax, let's presume that both Jane and John each have an estate of \$3.5 million. If Jane dies first, she could leave everything outright to John without her estate owing any federal estate tax because of what is called the "**unlimited marital deduction**."

However, upon John's later death, after using his \$3.5 million federal exemption, his estate would owe federal estate tax on the remaining \$3.5 million he owns (ignoring any growth in value). He could pass on \$3.5 million to his children (or anyone else) free of estate tax, but Joan's \$3.5 million exemption would be lost forever. That could cost the family over \$1.2 million in federal estate taxes!

Because of the State of Maine's lesser exemption, people now need to do additional planning to avoid paying Maine estate taxes at the first death.

Estate tax can be avoided or mitigated by leaving the federal exemption amount to a **Family Trust** for the benefit of the spouse/and or children or other beneficiaries, and anything over the exemption amount to the spouse, either outright or in a **Marital Trust** (or two Marital Trusts to avoid Maine estate tax at the first death).

John can be a beneficiary of the **Family Trust**, even the sole beneficiary. Joan's estate would still owe no tax. And John's estate would be able to use his exemption as well as Joan's exemption – saving a substantial amount of money. John would also be the beneficiary under the **Marital Trust**.

The concern of John losing control over use of the assets in the **Family Trust** can be easily mitigated. John can be given full use of both the income and principal of the trust for his health, education, maintenance and support. The term "health, education, maintenance and support" is a term of art – an IRS term of art. It is limiting language to insure that the exemption is maintained and that the IRS does not later determine that the assets in the Family Trust are really part of the unlimited marital deduction, and therefore taxed in the surviving spouse's estate.

However, this language allows John to live at the comfort level he had been living at or could now live at. The IRS' understanding and acceptance of the term "maintenance" is very broad, and can even include such things as a cruise trip the spouses never had a chance to enjoy because of work and home!

As well, in drafting the Family Trust provisions the spouses can allow each other after the death of the first to die, to change the eventual amount of distributions and how distributions are made to the ultimate beneficiaries (for instance, children) by the

utilization of what is called a **Limited Power of Appointment** (a power to decide who gets the balance of the Family Trust on the death of the second spouse to die). This allows flexibility caused by changed circumstances in the family after the death of the first spouse.

The Family Trust is a tax-free trust – estate tax free (not income tax-free). Assets in the trust that appreciate in value over the years do not incur additional federal estate tax. As well, these assets have the most creditor protection. For that reason the surviving spouse would be wise not to access these assets, unless necessary, prior to first depleting the assets in the survivor's own estate, and then second, depleting the assets in the Marital Trust. The reason for this suggestion is that the survivor's estate is taxable and has no asset protection (unless some of the assets are in an asset protection entity), and the assets in the Marital Trust, while they have asset protection, are taxable in the survivor's estate at death.

Of course, if the spouse owning few assets dies first, he or she could lose the opportunity to utilize the full exemption amount. This can be dealt with relatively easily by having the wealthier spouse transfer assets tax-free to the other spouse during life.

There are also situations in which the unlimited marital deduction can be used to save tax while at the same time addressing **non-tax concerns** by use of a **Marital Trust**, rather than giving the assets outright to the surviving spouse.

For example, there may be circumstances under which leaving all the funds outright to a spouse would not be desirable. Typically one or both spouses may be concerned about the management of the property, or creditor protection, or may want to make sure that particular beneficiaries ultimately get the property. This last concern arises most often when there are children of a prior marriage. The Marital Trust can be as broad or limiting as you choose and still qualify for the unlimited marital deduction. The only IRS requirement is that all the income from the property of the Marital Trust be given to the surviving spouse.

As you can see, the marital deduction and exemptions are powerful and flexible tools that can yield great benefits when properly coordinated. However, careful planning,

including taking into account income tax considerations, is necessary and should not be done without the help of a professional team of advisors.

This type of trust planning is not limited to taxable estates or married people. In second marriages where there is concern for children of the prior marriage, trust planning would be important to maintain the financial legacy you want to leave.

In situations where a beneficiary is disabled or receiving government benefits, or a child has potential for a failed marriage, or where a potential beneficiary is young or does not have the competence to handle his or her bequest, a trust would be appropriate.

And a final consideration: Some marital estates are under the taxable amount but could still be taxed on the death of the second spouse to die. This is the family situation in which one spouse's major asset is a large **IRA or other type of retirement account**. For example, assume husband's only asset is a large IRA and wife has all the other assets worth \$3.5 million. If husband leaves the IRA outright to wife by beneficiary designation, his estate has lost the use of his exemption. Upon wife's subsequent death, she will have a taxable estate! There are ways to avoid this but they must be reviewed very carefully, evaluating estate and income tax considerations.

If you wish to learn more and apply these rules to your own situation, please contact us for an appointment. **This is very complex planning and should not be done on one's own.**