

New Year Brings Changes in Estate Tax and Generation-Skipping Transfer Tax

By Richard S. Franklin¹

Beginning January 1, 2009, the estate and GST exemptions are increased to \$3.5 million, a 75% increase over last year's \$2 million exemptions. As a result, the number of federal estate tax returns that need to be filed will drop significantly. The Tax Policy Center estimates that about 17,550 taxable returns were filed in 2008, while only about 6,200 are expected to be filed in 2009. The IRS estimated that 17,416 taxable returns were filed in 2007. Of those, 9,892 were for gross estates less than \$3.5 million.²

A married couple with a combined estate of \$7 million or less should now be able to pass the entire amount to family members with no federal estate tax being imposed. To ensure that your clients' estate plans take full advantage of both spouses' \$3.5 million federal estate tax exemption consider:

Funding the Family Trust. Ensure that the asset allocation between the spouses is sufficient to allow the "Family Trust" or credit shelter trust of the first spouse to die to be fully funded, preferably without using retirement accounts or other items of income in respect of a decedent. If possible, ensure that both spouses have \$3.5 million of assets in their respective names or revocable trusts available to fund the Family Trust. If one spouse's assets are insufficient, consider making gifts from the wealthier spouse (being mindful however of marital law issues) or dividing jointly owned property (being mindful that severing a tenancy by the entirety may be poor planning for asset protection purposes). Another possibility is for the wealthier spouse to create an inter vivos marital trust (QTIP trust) for his or her spouse and make the QTIP election. Upon the donee spouse's death, the QTIP trust will be included in the donee spouse's estate under IRC section 2044 and thereby be available to use the donee spouse's estate tax exemption.

If a client's current will or revocable trust states that the Family Trust is to be funded with a specific amount, such as \$2 million, consider updating the provision to reflect the new exemption amount of \$3.5 million. If a QTIP trust has been previously established by the wealthier spouse with \$2 million or less, consider increasing the funding to \$3.5 million.

If the Family Trust is to be funded using a formula clause, check the will/revocable trust to ensure that the surviving spouse will be comfortable with the terms of the Family Trust now that a greater proportion of the estate will pass to the Family Trust rather than the Marital Trust. The terms of the Family Trust and its control by the appointed trustee could be skewed toward or away from the surviving spouse, and in some cases the surviving spouse may have been completely omitted as a beneficiary. For example, ten years ago in 1999, the estate tax exemption was \$650,000. At that time, a couple may have reasonably concluded that the Family Trust should benefit just the descendants, since the amount over \$650,000 would solely benefit the surviving spouse. However, now diverting a much greater amount - \$3.5 million - away from the surviving spouse may not be appropriate.

State Estate Tax Considerations. Many states such as California, Texas, and Virginia do not impose a separate estate tax, but about 15 states, including the District of Columbia, Maryland, and New York, do impose their own estate tax and allow only a \$1 million estate tax exemption.

In Maryland, the personal representative of the first spouse to die may qualify a portion of the Marital Trust for the Maryland estate tax marital deduction, but not the federal estate tax deduction. This state-only QTIP allows the full federal estate tax exemption of \$3.5 million of each spouse to be used, while deferring all Maryland estate taxes until the surviving spouse's death. The primary reason articulated for using the state-only QTIP is that the surviving spouse may leave the jurisdiction and thereby permanently avoid the state estate tax. However, if complete avoidance of the state death tax is not assured by a change in domicile or otherwise, there are reasons why a state-only QTIP may not be a good idea, including that (1) the lower brackets of the state estate tax table are not used in both estates; (2) when the surviving spouse dies, no federal death tax deduction is available with respect to state death taxes paid on the state-only QTIP;³ (3) all income of the state-only QTIP trust must be paid to the surviving spouse, the trust cannot have other beneficiaries, and any income paid and not spent or given away would be taxable in the surviving spouse's estate; and (4) there is likely to be less creditor protection compared to a discretionary Family Trust. The chart below illustrates that the state-only QTIP may increase the overall tax liability.

Comparison of Electing or Not Electing the Maryland State-Only QTIP			
Year of Deaths		2009	
Federal Applicable Exemption		3,500,000	
Maryland Exemption		1,000,000	
Growth Rate		0.00%	
	Plan #1 - Pay State Death Taxes on Full Family Trust Upon 1st Spouse's Death		Plan #2 - Pay No State Death Taxes Upon 1st Spouse's Death
1st Spouse's Death		1st Spouse's Death	
	Value of Estate 7,000,000		Value of Estate 7,000,000
	Value of Family Trust 3,270,800		Value of Family Trust 1,000,000
	Value of Federal & MD QTIP 3,500,000		Value MD QTIP 2,500,000
			Value of Federal & MD QTIP 3,500,000
	Federal Estate Taxes -		Federal Estate Taxes -
	Maryland Estate Taxes* 229,200		Maryland Estate Taxes -
	Total Taxes on 1st Death 229,200		Total Taxes on 1st Death -
2nd Spouse's Death		2nd Spouse's Death	
	Value of Federal & MD QTIP 3,500,000		Value of MD QTIP 2,500,000
			Value of Federal & MD QTIP 3,500,000
	Federal Estate Taxes -		Federal Estate Taxes -
	Maryland Estate Taxes 229,200		Maryland Estate Taxes 510,800
	Total Taxes on 2nd Death 229,200		Total Taxes on 2nd Death 510,800
Total Estate Taxes 1st and 2nd Deaths	458,400	Total Estate Taxes 1st and 2nd Deaths	510,800
Savings of Plan #1 over Plan #2**	52,400		

Notes:

*Assumes the taxes are charged to the Family Trust. If taxes are charged to the Marital Trust, thereby allowing the full \$3.5 million to fund the Family Trust, the taxes would increase to \$254,910.

**If the value of the 1st spouse's estate were \$10 million, the savings of Plan #1 over Plan #2 would be \$113,200.

Unfortunately, clients in DC and New York are generally limited to either funding the Family Trust with \$1 million and wasting \$2.5 million of the federal estate tax exemption, or fully funding the federal estate tax exemption at \$3.5 million and paying DC or New York estate taxes on \$2.5 million upon the first spouse's death.⁴ Prior to the increased federal exemption, the DC or New York estate tax under this latter alternative would have been about \$100,000 on the \$1 million of federal estate tax exemption exceeding the DC or New York \$1 million estate tax exemption. In 2009, the DC and New York estate tax will be about \$229,000 on the \$2.5 million of federal estate tax exemption exceeding the \$1 million DC or NY estate tax exemption. Incurring some state estate taxes upon the first spouse's death in exchange for fully utilizing the

federal exemption may provide overall estate tax savings when considering the aggregate taxes payable for both spouses.⁵

Increased GST Exemption. The additional \$1.5 million of GST exemption now available may be useful if a client has previously established an irrevocable life insurance trust, dynasty trust, GRAT remainder trust, or other similar types of irrevocable trusts. If such trust is partially exempt from the GST tax or if it includes two subtrusts, one exempt from the GST tax and one subject to it, the additional GST exemption can now be allocated to the partial inclusion ratio trust or nonexempt trust, thereby making it or some portion of it exempt from GST tax. This would be a so-called “late” allocation of GST exemption.⁶

For a client who is not likely to use his or her GST exemption during lifetime, ensure that the testamentary provisions in the will/revocable trust, when appropriate, are properly structured to use the exemption. There could be situations in which a testamentary provision provides for a fixed amount to be set aside in a GST trust, rather than using a formula based on the then GST exemption available. Consideration should be given to adjusting these clauses for the increased exemption.

Opportune Time for Estate Planning. A combination of factors may make this the opportune time to transfer assets to family members. First, recessionary pressures have driven down stock prices and the values of most companies, and volatility in the stock market means that equity interests in private companies may be subject to greater discounts for lack of marketability. Therefore, this is the time to freeze values for gift and estate tax purposes. Second, historically low interest rates are available, thereby (i) increasing the leverage of GRATs and CLATs, (ii) reducing the financing costs of sales and loans, and (iii) making it advantageous to refinance existing notes. Third, Congress is considering legislation that would, among other changes, limit the use of minority interest discounts for lack of control in valuing business interests transferred between family members. The potential loss of this discount would effectively increase federal gift and estate tax burdens.

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² The IRS statistics are available at: <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html>.

³ The federal estate tax deduction under IRC section 2058 for death taxes paid to a state is not applicable to taxes with respect to property not included within the federal gross estate. Some estate tax attorneys may have thought that the higher brackets of the state death tax table applicable to the state-only QTIP when the surviving spouse dies would be offset by the federal deduction for state death taxes – not so!

⁴ One partial solution is to consider funding the Family Trust with the \$1 million gift tax exemption amount before the first spouse’s death (but giving due consideration to income tax basis and market risks associated with gifts) as most states do not have a gift tax working in coordination with their estate tax. This allows the funding of the Family Trust with \$2 million with no state estate tax (i.e., \$1 million during lifetime that escapes state tax because there is no state gift tax and \$1 million upon death because of the state estate tax exemption of \$1 million). State estate tax would apply on the remaining \$1.5 million of the federal exemption upon the first spouse’s death.

⁵ DecoupleCruncher may be useful in modeling scenarios and can be obtained from <http://www.leimberg.com/>.

⁶ For the rules governing the late allocation of GST exemption see the regulations under IRC sections 2632 and 2642. A qualified severance may also be advisable.