

2008 ESTATE PLANNING YEAR IN REVIEW

“Hope is a waking dream .” - Aristotle (384 BC—322 BC)

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ESTATE TAX REPEAL? YOU'RE DREAMING

The federal estate tax is scheduled for repeal less than twelve months from now. Under current law the federal estate tax dies at midnight on December 31, 2009. On January 1, 2010, as the bedtime story goes, we will awaken to a world where unlimited wealth may be left to our children, grandchildren or other loved ones free of federal estate tax. If that sounds like a dream come true (or a nightmare, depending on your social and political view of the merits or evils of inherited wealth) - dream on. Although repeal remains part of current tax law, no one reasonably expects it to be the law when the calendar page turns to January 2010.

As recently as 1997, the amount that each person could leave on death to his or her non-spouse heirs, free of estate tax, was \$600,000 (we refer to the amount as the “coupon amount”; in Internal Revenue Code parlance, it is called the “applicable exclusion amount”). After 1997, the federal coupon amount began moving up each year, to \$625,000 in 1998; \$650,000 in 1999; \$675,000 in 2000. When President Clinton left office in January 2001, we had experienced three consecutive years of federal budget surplus: \$69 billion in 1998, \$125 billion in 1999, and \$236 billion in 2000. Before those three years, the country had not experienced a budget surplus since 1969. In 2001, with the surplus burning a hole in Uncle Sam’s pocket, Congress passed a number of tax cuts that became

known as “the Bush tax cuts.” One of these tax cuts was an increase in the federal coupon amount.

Congress phased in an increase of the coupon amount as follows:

2002 – 2003	- \$1 million
2004 – 2005	- \$1.5 million
2006 – 2008	- \$2 million
2009	- \$3.5 million
2010	- Unlimited (estate tax “repeal”)
2011+	- \$1 million

The 2001 tax law remains in effect today. The federal coupon is now \$3.5 million with the estate tax scheduled for repeal at the end of 2009.

No one who has been following the federal budget woes actually expects the estate tax to be repealed in 2010. The budget euphoria that led to the 2001 tax cuts has turned depressive. In contrast to the three consecutive years of budget surplus that preceded President Bush’s eight years in office, we recorded a federal budget deficit of \$161.5 billion in 2007, \$455 billion in 2008, and are projecting a deficit of \$1 trillion+ in 2009. In the face of such daunting budget shortfalls, repeal of the estate tax is both politically and fiscally unrealistic.

Immediately after President-elect Obama takes office this month, expect Congress to pass an economic stimulus package. After the stimulus package is in place, Congress will likely begin working on the estate tax. Although predicting Congress’ actions is a risky endeavor, the expectation is that Congress will make the current 2009 law

“permanent” (meaning, until Congress changes it again) – a \$3.5 million exemption (\$7 million per husband and wife), and index the exemption to the consumer price index to adjust for future inflation.

Over the last year, the Senate Finance Committee held three hearings to explore estate tax reform or repeal. Although the Senate Finance Committee heard testimony on alternative systems to taxing wealth, an abandonment of the estate tax in favor of an entirely new system of taxing the generational transfer of wealth seems improbable anytime soon. Instead, estate tax reform is expected. In addition to addressing the size of the federal coupon amount, other *possible* reforms include:

- Freezing the estate tax rate at 45%. The federal estate tax rate is now a flat 45% on the amount of the estate in excess of the federal coupon.
- Unifying the gift and estate tax exemptions. Although the federal estate tax exemption is now \$3.5 million, the gift tax exemption is only \$1 million. Therefore, a person may only make \$1 million of lifetime gifts before a gift tax is imposed. Before 2001, the gift and estate tax exemptions were “unified” – the same amount applied to transfers during life and upon death. Re-unifying the exemptions to have a single amount apply to lifetime gifts and to transfers at death would simplify planning and take away the current disincentive to making large lifetime gifts.
- Making any unused portion of a decedent’s federal coupon “portable” or transferable to a surviving spouse. Under current law, if the coupon isn’t used at the time a person dies, the unused portion of the coupon is lost; it is not transferable. Think of the coupon as saying, in fine print, “Non-transferable. Expires at death.” An example: husband

dies with \$2 million of assets and has a simple Will that leaves everything to his wife. Because there is no estate tax on a decedent’s transfer of assets to his or her spouse, there is no estate tax at husband’s death and his coupon is not used when he leaves his assets outright to his wife. Wife dies the following year with \$4.5 million of assets. Wife has a \$3.5 million federal estate tax coupon that exempts the first \$3.5 million of assets from tax. The \$1 million of assets that she owned at her death in excess of the amount of her coupon is subject to federal estate tax of \$450,000 (a flat 45%). Wife didn’t inherit husband’s unused coupon, and when he left everything outright to her upon his death, his coupon went unused. If the federal coupon becomes portable and transferable to a surviving spouse, any unused portion of a decedent’s coupon will be made available to his or her surviving spouse. With a portable coupon, under the example given, wife would inherit her husband’s entire coupon, she would have died with \$7 million worth of coupon, and there would be no estate tax payable at the time of her death when she left \$4.5 million of assets to their children. The attraction of a portable federal coupon is that it would permit married couples to avoid complicated estate planning that requires the creation of a trust at the time of the death of the first spouse, and would be consistent with what many spouses want to do with their assets absent tax considerations - - leave everything outright to the surviving spouse. It would also reduce the importance of re-titling assets as part of the estate planning process to ensure that each spouse owns, in his or her own name, assets sufficient to use the spouse’s federal coupon if the spouse is the first to die. If the federal coupon becomes portable and transferable to a surviving spouse, will

Maine do the same? We'll see. If Congress makes the coupon portable and Maine doesn't follow Congress' lead, then married couples residing in Maine may still need to create a trust at the death of the first spouse to die to avoid wasting the Maine coupon of the first spouse to die.

- Limiting the use of trusts that are designed to shelter assets from estate tax for more than one generation. Currently many states, including Maine, permit the creation of trusts to benefit family members from generation to generation, perpetually, without ever exposing the trust assets to estate tax. A reform package could limit trusts to skipping only one generation before the assets are exposed to estate tax.
- Restricting the use of valuation discount planning for any asset other than an operating business. Estate planning has commonly taken advantage of valuation adjustments (discounts) for a fractional interest in an asset or for interests in partnerships, corporations and limited liability companies that are non-controlling and that are not readily marketable. The IRS would like to see Congress restrict the use of valuation adjustments.
- Limiting the use of withdrawal right powers that currently allow gifts to qualify for the annual exclusion. Current law permits gifts to trusts to qualify for the annual gift exclusion if a trust beneficiary has the right to withdraw the gift to the trust at the time the gift is made.

Which of these possible reforms will become law remains to be seen. We won't need to wait long to find out.

THE MAINE ESTATE TAX

In 2003 Maine created its own estate tax by creating a separate estate tax exemption (a "state coupon," so to speak). The Maine coupon is currently \$1 million and is not scheduled to increase beyond that amount.

In contrast to the federal estate tax, which is a flat 45% on the amount of the estate in

excess of the federal coupon, the Maine estate tax computation is a bit more convoluted. As a rough calculation, however, for estates of several million dollars the Maine estate tax is approximately 10% of the amount of the estate in excess of \$1 million. The rate is graduated, topping out at 16% on estates greater than \$10 million. The Maine estate tax is \$99,600 on an estate of \$2 million, \$229,200 on an estate of \$3.5 million, \$510,000 on an estate of \$6 million, and \$1,067,000 on an estate of \$10 million.

By creating its own estate tax system with a coupon that is less than the federal coupon, Maine imposes an estate tax in addition to the federal estate tax, and there will be many circumstances when a Maine estate tax is due even though there is no federal estate tax due.

Under many estate plans created for married couples, the will or revocable trust creates one or more trusts at the time of the first spouse to die. The formula for determining the amount of assets used to fund the trust(s) is designed to avoid all estate taxes (both state and federal) at the time of the first spouse to die and minimize estate taxes at the death of the surviving spouse. Before Maine created its own estate tax in 2003, the formula was customarily based on the amount of the federal coupon because at the time the estate plans were created there was no Maine coupon and no Maine estate tax to avoid. With the Maine coupon now being \$2.5 million less than the federal coupon, the traditional formula for determining the amount of assets used to fund the trust(s) at the time of the first spouse to die could result in Maine estate tax due of \$229,200 at the death of the first spouse even though at the time the will or revocable trust was written the expectation was that no estate tax would be payable at the time of the first death.

Maine has revised its estate tax laws since creating the separate Maine estate tax. If your will or revocable trust creates a trust for your surviving spouse and you have not had your estate planning documents reviewed since 2005, you are overdue to have them reviewed, if for no other reason than to ensure that the estate tax planning is up to date with current law and to avoid the payment of Maine estate tax at the first death.

THE FEDERAL GIFT TAX

As of January 1, 2009 the annual gift tax exclusion increased from \$12,000 to \$13,000. The annual gift exclusion permits a person to give \$13,000 a year to as many recipients as desired, without eroding the lifetime federal gift or death coupon amount. A married couple can elect to split gifts, which will allow the couple to make gifts of up to \$26,000 to a single recipient in 2009 free of gift tax consequences.

Payments of tuition expenses and certain medical expenses are not subject to gift tax and may be made in addition to the annual gift tax exclusion of \$13,000.

Maine has no gift tax.

RETIREMENT ACCOUNTS AND 2009 REQUIRED MINIMUM DISTRIBUTIONS

Generally, the owner of a retirement account who has reached age 70½ must begin taking required minimum distributions (RMDs) from the account. A person who owns an inherited retirement account must take RMDs from the inherited account, regardless of the person's age, beginning with the year following the year of the decedent's death. If you are taking RMDs from a retirement account under either of the above circumstances, you can skip your 2009 RMD without penalty.

In December 2008, in an effort to acknowledge the effect that the precipitous decline in the investment markets has had

on retirement accounts, Congress passed, and President Bush signed into law, the "Worker, Retiree and Employer Recovery Act," which waives the RMD for calendar year 2009. The idea behind the waiver is to help retirees and beneficiaries of inherited retirement accounts who would otherwise have to sell depleted-in-value stocks and mutual funds to satisfy their 2009 RMD. The waiver applies only to the 2009 RMD. The next RMD will be for calendar year 2010.

STATE OF THE ESTATE REVIEW

"A man should not leave this earth with unfinished business. He should live each day as if it was a pre-flight check. He should ask each morning, am I prepared to lift-off?"

Northern Exposure, All is Vanity (1991)

With apologies for quoting from television popular culture, for those who may not have been fans of the show, *Northern Exposure* was an award winning television series that ran in the early to mid '90s, chronicling the life of a newly graduated physician practicing medicine in a small town in the wilds of Alaska.

The quote summarizes what we have always emphasized about estate planning - the non-tax reasons for planning.

With the dramatic increase in the federal estate tax exemption amount from \$600,000 in 1997 to \$3.5 million in 2009, a married couple who haven't updated their estate planning since the late '90s may have estate planning documents that create one or more trusts for the surviving spouse that are no longer needed. A renewed discussion is important to determine how much control the surviving spouse should have over the assets of the first spouse to die. If the only reason for creating a trust at the first spouse's death was for federal estate tax planning purposes, the nearly six-fold increase in the federal coupon in the last eleven years may make the trust

unnecessary. On the other hand, for reasons that have nothing to do with estate tax, there may be compelling reasons why a trust for the benefit of the surviving spouse is desirable. There may be a desire to provide the surviving spouse with creditor protection or predator (re-marriage) protection, ensure that children from the present marriage or a prior marriage are not disinherited, or provide the surviving spouse with the management assistance of a trusted family member or a professional investment manager.

Similar reasons can make trusts for children an attractive or compelling option to outright inheritance. Under Maine law, a beneficiary can be the sole trustee of his or her own trust, and as long as the trust limits the beneficiary to distributions for education, health, support and maintenance, the beneficiary's creditors cannot reach the trust assets. A beneficiary who is receiving government assistance benefits may lose their benefits if they receive their inheritance outright instead of in a properly structured trust.

Estate planning always has been and always will be an intensely personal process. We pride ourselves in helping our clients explore the various options available to them to creatively and efficiently meet their planning goals. One size does not fit all; it never will. Similarly, it is unrealistic to think that a form Will or trust can meet your planning goals.

Our *State of the Estate Review* is an acknowledgement that estate planning is a process, not an event. It is reasonable to expect that decisions we make in one year will, in light of additional life experience, be subject to change to match our evolution of thought, changes in the law, changes in our finances and changes in the life status of our beneficiaries. Planning goals evolve.

The frequency with which you update your

estate plan is left to your discretion. However, if it has been more than a few years since you updated your plan, we encourage you to call to schedule a *State of the Estate Review* for a "walk through" of your existing estate planning documents and to discuss updates that may be appropriate for both tax and non-tax reasons. Are existing trusts still necessary or appropriate? What is the ideal way for a beneficiary to inherit? What is the best balance between giving a beneficiary control over his or her inheritance and providing the beneficiary with protection from current or future creditors and predators? Who is the appropriate person to make health care and financial decisions for you if you are unable to do so yourself? Who is the right person to serve as personal representative of your estate upon your death? Are the beneficiary designations of your retirement accounts, annuities and life insurance policies consistent with the rest of your estate plan?

Just as our clients' planning goals evolve, our professional experience and continuing education provide us with new insights, approaches, and techniques to accomplish planning goals. If you want to be sure your estate planning documents are cutting edge with planning and drafting techniques, call us to schedule a *State of the Estate Review*.

Absent your request to schedule a *State of the Estate Review*, we will not be responsible for reviewing or updating your estate plan to reflect changes in the law or for other purposes.

CONGRATULATIONS (AGAIN) TO OUR OWN

David Backer and John Kaminski were both listed this year in *Super Lawyers*, which is recognition by their peers that they are among the top 5% of all trust and estate planning lawyers in Maine. John was also

listed in *Super Lawyers* in the practice areas of tax and real estate law.

David and John are also both recognized by *Best Lawyers in America* - - David for his work in trust and estate planning, and John for his work in tax law. Both David and John are elected Fellows of the American College of Trust and Estate Counsel, a professional association of lawyers from throughout the United States. Fellows of the College are nominated by other Fellows in their geographic area and are elected by the membership at large. A lawyer cannot apply for membership in the College. Fellows are selected on the basis of professional reputation and ability in the fields of trusts and estates.

Along with David and John, 21 other lawyers at Drummond Woodsum have been recognized by *Best Lawyers in America* and/or *Super Lawyers* for their work in the fields of commercial litigation, Native American law, education law, labor and employment law, banking law, corporate law, mergers and acquisitions law, bankruptcy and creditor-debtor rights law, land use and zoning law, municipal law, real estate law and public finance law.

LOOSE ENDS

"If the rich could hire other people to die for them, the poor could make a wonderful living." -
Yiddish Proverb

- 2008 was a year that most of us were glad to leave behind. Unless you had the foresight to cash out all your investments on December 31, 2007, you likely feel poorer today than this time last year. You're in good company. The best economists and investment gurus in the world didn't foresee the vortex that dragged down the investment markets this year. With a new administration entering the White House and the governments of the world's most

powerful countries focused on stimulating the global economy, we all hope for (dream of?) better days ahead.

- Jessica Emmons, who has been part of Drummond Woodsum's Business Services Group for three years, has joined the trust and estate planning group. She will continue to work on transactional business matters as she spends increasingly more time in estate planning. Jessica was born and bred in Maine, went to the University of Pennsylvania for her undergraduate degree, returned to Maine for law school and is "wicked" smart. We're glad to have Jessica and are sure you'll enjoy working with her.

- We've moved. In case you haven't seen, on November 1 we moved our offices from Commercial Street to Marginal Way on the other side of the Portland peninsula. Although leaving the Old Port was bittersweet for many of us, we outgrew the 140+ year old buildings on Commercial Street that had been the firm's home for 26 years. The new building on Marginal Way gives us wonderful visibility in the Bayside neighborhood, and provides easy access for our clients, plenty of undercover parking in our own garage, and space for our future growth.

Thank you for entrusting us with your estate planning. We take seriously the trust that you place in us and will continue to do everything possible to continue to earn your trust.

Best wishes to you and your loved ones for a New Year filled with good health, prosperity and peace.

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication was not intended or written to be used, and cannot be used for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or tax related matter.

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