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2009 Estate Planning Year in Review

"The reports of my death are greatly exaggerated."
Mark Twain

Federal Estate Tax is Dead

A year ago, in the *2008 Estate Planning Year in Review*, we wrote that if you thought that you would awaken on January 1, 2010 to find the federal estate tax repealed, you were dreaming. Pinch yourself. You're wide awake and the federal estate tax is dead . . . at least for now. The question is whether Congress will do a bit of voodoo magic to bring it back from the dead.

Here's the story of how we got to a place where no one thought we would end up.

How We Got Here

In 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"). When President George W. Bush took office in 2001, with the country awash in budget surplus Congress passed a number of tax cuts. Among these cuts were an increase in the federal coupon amount and a gradual decrease of the top federal estate tax rate from 55% (plus a 5% surcharge on estates over $10 million) to 45%.

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")

The 2001 tax law remains in effect today, which means that as of January 1, 2010 the federal estate tax was repealed. In addition, the generation skipping transfer tax, which was imposed on transfers to grandchildren and subsequent generations of descendants, was repealed. No one who has been following the federal budget woes and monitoring estate tax developments over the last several years expected this to happen.

With a projected deficit of $1.6+ trillion in the fiscal 2009 federal budget, how did Congress justify repealing a tax on individual estates in excess of $3.5 million ($7 million for a married couple)?

Congress didn't take any affirmative action to repeal the estate tax. Rather, repeal happened because Congress did nothing to stop it. As the clock ticked down on the final weeks of 2009, the Senate's attention was focused on health care reform, and estate tax reform fell by the wayside. There were a number of attempts during 2009 to head off estate tax repeal, all of which were unsuccessful. Senate Democrats are divided over the size of the coupon (many favor a $5 million exemption) and many Republicans oppose the estate tax entirely. As we came closer to the end of the year Congress simply ran out of options and time for crafting a compromise to head off repeal.

A quirk of the current tax law is that repeal is only in effect for calendar year 2010. It's therefore a bit of a misrepresentation to refer to it as repeal. A more accurate description is to call it a one year suspension of the estate tax. The 2001 tax law included a "sunset" provision (a Cinderella story "turning into a pumpkin at midnight" type of provision) that will result in the federal coupon reverting to $1 million and the generation skipping transfer tax being reinstated on transfers in excess of $1 million as of January 1, 2011. Will that happen? We're hardly in a position to predict what Congress will or won't do. After all, we and virtually everyone else guessed wrong on whether Congress would permit the estate tax to be repealed in 2010. All bets were that Congress would act during 2009 to make the $3.5 million coupon permanent, or increase it to as much as $5 million and index it to inflation for future increases. Those who make a living reading Congressional tea leaves are predicting that sometime in 2010 Congress will reinstate the federal estate tax and likely make the reinstatement retroactive to January 1, 2010. Any retroactivity will result in constitutional challenges. Complicating any predictions about how Congress deals with the estate tax are legislators' perception of how the voters will react in the November 2010 mid-term elections.

It is important to note that in all the predictions about what Congress was expected to do, there was no talk of repeal being made permanent. If Congress acts during 2010, it is expected that the $3.5 million coupon that was in place in 2009 will be made permanent, or increased to as much as $5 million. If Congress fails to achieve some type of consensus during 2010, the coupon will revert to $1 million on January 1, 2011.

In addition to the repeal of the estate tax, the arrival of 2010 brought another major change affecting the estates of people who die in 2010. Up until this year, when a person died, most assets in the estate received a new income tax cost basis equal to the value of the assets on the date of death. The new date of death value cost basis is referred to as a "stepped-up" cost basis (or stepped-down, if the date of death value is less than the decedent's original cost basis). The benefit of the step-up in cost basis is that the decedent's heirs didn't incur any capital gain when they sold assets shortly after death. For example if you bought a vacation home 25 years ago for $150,000, and you sell it today for $750,000, you have a capital gain of $600,000 at the time of sale. On the other hand, if you still owned the vacation home at the time of your death, and the date of death value was $750,000, and your heirs sold the home for $750,000, they incurred no capital gain; the property received a step-up in cost basis equal to the date of death value. This unlimited step-up in basis is not available to the estates of people who die in 2010.

Under the 2010 rules, a "modified carryover basis" applies. The decedent's original cost basis is carried over to (or inherited by) the decedent's beneficiaries. There are opportunities to soften the effect of the carryover basis rules, but the new rules will be complex and will be a hardship for estates that have to implement them. Under the old step-up in basis rules, problems resulting from a decedent's poor record keeping of an asset's purchase price were cured at death, since the original purchase price became immaterial as of the date of death. Do you have the original cost basis information records for all your assets available for your Personal Representative?

Estate of Confusion

For the past 10 years estate planners and our clients have been left in limbo about long term estate tax planning decisions, but confident that Congress would bring us back into a state of certainty no later than 2009. Contrary to virtually everyone's expectations, 2010 arrived without Congress taking action and as a result, instead of planning in a time of certainty, we're left in a continuing estate of confusion.

What should you do now in light of the uncertainty? Bottom line, if you have more than a modest amount of wealth, now would be a great time to die, before Congress acts to reinstate the estate tax or before the tax reappears on January 1, 2011, whichever comes first. Sound like a joke? As macabre as that may sound, when it became apparent in the last several days of December that Congress was unlikely to take action to head off the impending repeal of the estate tax, there were reports of wealthy families keeping a dying patriarch or matriarch on life support until January 1, 2010 so the family wealth could pass estate tax free to the next generation. Whether that's true or not, we don't know, but it's not as farfetched as it might sound.

Short of opting to die this year, the question for us and our clients is, "Now what?" Is there something we should be doing immediately or should we wait another several months to see if Congress reinstates the estate tax? Do we wait until January 1, 2011 to see if Congress, by doing nothing in 2010, permits the estate tax to come back via the sunset provisions of the 2001 tax law? The answer depends on your propensity for risk, the size of your taxable estate and the terms of your existing estate plan.

Many wills and revocable trusts provide for gifts or distributions to be made by reference to a formula based on the amount of the unused estate tax coupon. For example, it is fairly common for the estate plan of a married individual to provide that at the time of his/her death, the estate should be divided into two portions: one portion equal to the unused estate tax coupon (typically distributed to a Family Trust - often called a credit shelter trust for the benefit of the surviving spouse and descendants) and the other portion passing outright to a spouse or to a Marital Trust for the surviving spouse's benefit. In many estate plans, the language used to divide the estate into two portions refers to the "amount necessary to reduce my federal estate tax to zero." The formula was used because it produced what appeared to be the optimal division or disposition of a decedent's property, but the formula has no meaning if the federal estate tax is no longer part of the tax law.

In Maine, most estate plans created in the last 4 or 5 years won't have that problem because the formula uses language referring to the "amount necessary to reduce all estate tax, *federal or state*, to zero," which will still be effective to divide the estate into two portions as intended.

If your will or revocable trust uses a formula provision to divide your estate at the time of your death, and you haven't had your estate plan updated since 2004, call us to schedule an appointment to review your estate plan. Similarly, if your estate plan uses a formula based on the amount of your unused estate tax coupon to make gifts, you need to review your estate plan. Failure to update your estate plan could have unintended and undesirable consequences to your spouse, partner, descendants, or other beneficiaries.

During this brief period of generation skipping transfer tax repeal, there may be creative options available to shift large amounts of wealth to subsequent generations. There will be risk involved in any wealth transfer techniques used during this window of opportunity, especially if Congress makes changes to the tax laws this year and makes the changes retroactive to January 1, 2010. If you have an interest in discussing any of those opportunities, let us know.

Stay tuned as we watch to see what the next chapter is in this unfolding saga. As Mark Twain said about his own reported death, announcements of the demise of the estate tax are likely to be greatly exaggerated.

The Maine Estate Tax

In 2003, in response to Congress passing the 2001 tax laws that increased the federal estate tax coupon, 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, is not scheduled to increase beyond that amount and is not affected by the repeal of the federal estate tax.

By creating its own estate tax system and a coupon amount that is not linked to the federal coupon, there will be many times when a Maine estate tax is due even though there is no federal estate tax due.

Maine did make one change to its estate tax computation in 2009. For Maine residents who die in 2009 or later, taxable gifts made within one year of the date of death will be added back into the decedent's taxable estate. Until this change, all lifetime taxable gifts escaped inclusion in the Maine taxable estate.

The Federal Gift Tax

The repeal of the federal *estate* tax did not repeal the federal *gift* tax. The annual gift tax exclusion remains $13,000 and 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, allowing the couple to make gifts of up to $26,000 to a single recipient in 2010 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.

The lifetime gift coupon is $1 million. For gifts made in 2010, if the lifetime gift coupon has been used in full, gifts in excess of the annual gift tax exclusion will be taxed at 35%, down from 45% in 2009. Unlimited lifetime transfers between U.S. citizen spouses remain gift tax free. In 2010, the first $134,000 of a lifetime transfer to a non-citizen spouse is gift tax free.

Maine has no separate gift tax.

Conversion of Traditional IRAs to Roth IRAs

Generally, there are two kinds of Individual Retirement Accounts (IRAs) – traditional IRAs and Roth IRAs.

Contributions to a traditional IRA are tax deductible and the assets in a traditional IRA grow tax deferred. All distributions from a traditional IRA are taxed as ordinary income in the year of the distribution. The owner of a traditional IRA must begin taking required minimum distributions from the account at age 70½.

Contributions to a Roth IRA are non-deductible, but if the contributions remain in the account for at least five years and the account owner is at least 59½, distributions are not taxable. The owner of a Roth IRA is not subject to the required minimum distribution rules of a traditional IRA. Therefore, the owner of a Roth IRA is never required to withdraw funds from the account and may let it grow tax free for the owner's entire lifetime.

Until 2010 there were income limits on people who were eligible to convert a traditional IRA to a Roth IRA. As of 2010, the income ceiling has been lifted, permitting anyone to convert a traditional IRA to a Roth IRA. Converting a traditional IRA to a Roth IRA will require the payment of income tax on the value of the assets converted to a Roth IRA. Individuals considering converting a traditional IRA to a Roth IRA should weigh the financial cost of paying income tax on the value of the converted assets against the benefit of tax free withdrawals from a Roth

IRA and avoiding required minimum distributions from a Roth IRA.

Does conversion make sense for you? The answer will depend on a number of factors, including (i) your age at the time of conversion (generally, the more years the assets have to grow in the Roth IRA before you need to draw on them for retirement spending, the greater the benefit of conversion), (ii) whether you have other assets outside the IRA that can be used to pay the income tax due as a result of the conversion (generally, the more wealth that can be shifted into the tax free Roth IRA, the greater the benefit of conversion), (iii) your expected income tax rate at the time you plan to begin withdrawing funds from the Roth IRA (the less the expected decline in the effective income tax rate between the time of conversion and the time of retirement, the greater the benefit of conversion), and (iv) whether you ever expect to draw on the Roth IRA assets during your lifetime or whether the account is likely to be left to the next generation at the time of your death (generally, the benefit of conversion will be greater if the Roth IRA is likely to be left intact for beneficiaries who, in turn, will permit the account to continue to grow tax free as long as possible).

Most financial advisors will have the ability to assist you with the analysis necessary to enable you to make an informed decision about whether conversion of your traditional IRA to a Roth IRA makes sense. If you need a recommendation for someone who can help you with that analysis, let us know and we'll be happy to find someone who can help you.

State of the Estate Review

An estate plan is like a parachute. You only need it once and you want to make sure it works when you need it. To make sure it works as intended, you need to repack it occasionally.

Estate planning has always been and will always be an intensely personal process. We pride ourselves in helping clients explore the various options available 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. We often get a phone call from a prospective new client with the question, "How much does it cost for a will?" It's not unlike calling your doctor and saying, "I've got a pain in my chest. How much will it cost to make me feel better?" We don't have a fixed cost for "a will." Everyone has different dreams and goals for themselves and the people they love. Our job is to help them realize those dreams and goals. We can't begin to know what documents are appropriate for our clients until they teach us about themselves. Similarly, our clients can't know what options are best for them until we teach them about the various options available. It's a two way relationship. We each have much to learn before an estate plan can be designed and created.

Our *State of the Estate Review* is an acknowledgement that estate planning is a process, not an event. It is reasonable to expect that the 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 finances and changes in the life status of our beneficiaries.

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.

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, 28 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, intellectual property law, mergers and acquisitions law, bankruptcy and creditor-debtor rights law, land use and zoning law, municipal law, real estate law, public finance law and alternative dispute resolution.

Probate and Trust Law Advisory Commission

In 2009, the Maine Legislature approved and the Governor signed legislation creating the Probate and Trust Law Advisory Commission. The Commission is charged with conducting a continuing study of the probate and trust laws in Maine and making recommendations to the Legislature for improvements in Maine's probate and trust laws. David Backer was instrumental in promoting the legislation that created the Commission and he appeared before the Judiciary Committee to encourage support for the legislation.

David was appointed by the Chief Justice of the Maine Supreme Judicial Court as a member of the Commission, to serve with four other members of the Maine State Bar Association's Trust and Estate Section, two Probate Court Judges, one Superior Court Judge, the Attorney General, and an individual appointed by the Governor to represent the interests of older people.

Thank You for Your Trust

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.

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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.

