DrummondWoodsum 2014

Estate Planning Year in Review

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I Just Want to Do Something Simple

> *"For every complex problem there is an answer that is clear, simple, and wrong."*
>
> - Henry Louis ("H.L.") Mencken (1880 - 1956)

When we meet with people for the first time to talk about their estate planning, and we ask them to share their vision of what they have in mind, what we often hear is, "I just want to do something simple." We're still waiting for someone to look us in the eye and say, "I want to do something really complicated." That never happens.

When the conversation shifts to the details of the clients' goals, concerns, family, and assets, it's not unusual to learn some combination of the following:

- One or both clients have children from a previous relationship,
- The clients want to make sure that the surviving spouse's standard of living is protected and that if the surviving spouse remarries, the assets don't pass to the new spouse,
- The value of the entire estate is large enough to be subject to estate tax (Maine and/or federal) if no planning is put in place to minimize or eliminate the tax,
- One or more of the children are minors,
- A child is receiving government assistance benefits - usually MaineCare (Medicaid) and Supplemental Security Income (SSI) - as a result of a disability, and the client wants to ensure that the child's eligibility for those benefits is protected,
- One spouse owns a business that should be addressed in some manner in the planning,
- There is a seasonal vacation home that the clients want to preserve for use by children and grandchildren,

- There is concern about a child's inheritance being subject to division in a divorce proceeding if the child's marriage ends,
- There is concern about the assets being squandered by a child who hasn't yet demonstrated the ability to be a good financial manager,

. . . the list goes on.

We understand the desire for simplicity in an estate plan. Successfully and fully addressing all planning goals doesn't mean that an estate plan has to be complex. We like to think that there is a middle ground – a sweet spot – where all goals are addressed, the client fully understands the plan and sees creativity and beauty in the design, and the beneficiaries see and appreciate the benefits of the plan as designed and implemented. In a nutshell, that is our goal with every estate plan we create.

We also understand the unspoken message that is conveyed to us when a client says, "I just want to do something simple." The client often is saying, "Don't charge me very much." We always want to be a good steward of our clients' resources, and it's important to us that our clients see full value in what we provide for the fee paid. As consumers of goods and services, we all prefer to know what something will cost before we buy it. In most cases, once we understand the scope of the work we're being asked to do, we can quote a fixed fee, rather than an hourly rate. If the client is comfortable with the quoted fee and the fee is within the client's budget, which we find is almost always the case, we'll move forward with the design and implementation of the plan. Although the estate planning documents are the physical manifestation of our "deliverable," we sometimes like to say that the documents are free - - the real value is in the advice we provide and the depth of the conversation we have that results in the design manifested in the written documents.

We bring creativity and insight to the design of every plan we create, and our clients can have confidence that we will always counsel against creating unnecessary complexity.

Pick Your Poison

"Life is a sum of all your choices."

- Albert Camus (1913 - 1960)

After clients tell us that they just want to do something simple, one of the first things we often hear when clients tell us their estate planning goals is, "we want to avoid estate taxes." For married couples, estate plans are typically designed to ensure that no estate tax is due at the first spouse's death and that the payment of any estate tax is deferred until the death of the surviving spouse. Deferring payment of estate tax until the death of the surviving spouse is easy, because transferring assets outright to a spouse has never been subject to estate tax (assuming the surviving spouse is a U.S. citizen). But, minimizing or eliminating the estate tax burden at the surviving spouse's death often requires that tax savings provisions be incorporated in the estate planning documents of the first spouse to die.

Until a few years ago, the rule for the federal estate tax exemption was "use it or lose it" - if a married couple had combined assets that exceeded the amount exempt from federal estate tax, the first spouse to die needed to use the exemption amount at death to protect as much of the couple's assets as possible from estate tax. If the exemption was not used at the first death, it was lost.

To avoid wasting the estate tax exemption, the estate plan of the first spouse to die typically directed a portion of the assets to a trust for the benefit of the surviving spouse (often called a Family, Bypass, or Credit Shelter Trust), and the exemption amount was used to "shelter" those assets from estate tax. The surviving spouse then had the benefit of the trust for life, and at death the balance of the trust assets went to the children, free of estate tax. The surviving spouse used her own exemption amount at her death to protect as much of her own assets as possible, and those, too, went to the children with no (or reduced) estate tax.

Beginning in 2011, the federal estate tax exemption became "portable" . . . transferable to the surviving spouse. It's a wonderful concept that can simplify estate tax planning for spouses. With portability now in place, and with each spouse having a $5.43 million federal estate tax exemption in 2015 (scheduled to increase with inflation each year), a married couple may leave up to $10.86 million in assets to their children without creating a trust for the surviving spouse at the first spouse's death. When one spouse dies and leaves all assets to the surviving spouse through beneficiary designations, joint ownership and a simple will, the surviving spouse will own all of the couple's assets. With portability, the surviving spouse will also inherit the deceased spouse's unused exemption amount.

The natural consequence of the increase in the federal estate tax exemption, and of the exemption being portable to the surviving spouse, is that with each passing year fewer estates are large enough to be subject to federal estate tax. Because there is no state estate tax in New Hampshire, this is where the tax planning story ends for New Hampshire residents.

Unfortunately, that is not the end of the story for Maine residents. In 2003, Maine implemented its own estate tax, which operates under an entirely separate regime from the federal estate tax. The Maine estate tax exemption is $2 million, in contrast to the $5.43 million federal exemption. The Maine estate tax rate begins at 8% for estates over $2 million, increases to 10% for estates over $5 million, and climbs to 12% for estates over $8 million. The federal estate tax rate is a flat 40% on all amounts over the federal exemption amount.

In the last couple years a new dog has shown up in the yard, and it's almost as big as the one that bit us with the federal estate tax rate.

The Maine estate tax exemption is not portable. Therefore, as was the case before the federal estate tax became portable, the Maine estate tax savings provisions need to be included in the estate planning documents of the first spouse to die – which usually means creating a trust for the benefit of the surviving spouse.

The federal estate tax has traditionally been treated as the big dog in the yard that justified most of our attention. The vast differential in federal vs. Maine state estate tax rates (40% vs. 8% at threshold rates today) always justified the extra attention to the federal estate tax for our Maine resident clients. However, with current estate tax exemption amounts - $5.43 million for federal estate tax, and $2 million for Maine estate tax – and with portability now permitting married couples to transfer as much as $10.86 million to their descendants - many Maine and New Hampshire estates will not be subject to federal estate tax, but many Maine estates will be subject to Maine estate tax.

Although most families will never pay federal estate tax, in the last couple years a new dog has shown up in the yard, and it's almost as big as the one that bit us with the federal estate tax rate.

When a trust is created to minimize federal estate tax, creating the trust meant forgoing opportunities to minimize long-term capital gain tax, which in recent years had a top rate of 15%. The trade-off of paying capital gain tax in lieu of federal estate tax occurred because of a concept known as the "step-up" in cost basis. Federal tax law has long permitted an increase in the income tax cost basis of assets owned by a person at death. The result of the step-up is that heirs inherit the decedent's assets with a cost basis equal to the date of death value of the assets, rather than the decedent's cost basis.

In contrast, when a person makes lifetime gifts, the recipient of the gift receives the asset at the donor's original cost basis – known as "carry-over" basis. As a result, there is a distinct income tax advantage for an heir to inherit an asset at death rather than receive it by a lifetime gift if the decedent/donor has a low cost basis in the asset. For example, assume Mom owns a vacation property that she purchased for $100,000 and the property is now worth $800,000. If Mom gifts the property to her children today, and the children later sell the property for $850,000, they'll incur capital gain of $750,000 (the sale price minus the $100,000 carry-over cost basis that they received from Mom). In contrast, if Mom dies this year and leaves the property to her children as part of her estate planning, and the date of death value of the property is $800,000, when they later sell the property for $850,000, they'll incur capital gain of only $50,000 (the sale price minus the $800,000 stepped-up cost basis that they received from Mom at her death).

As far as we know, the step-up in cost basis is the only benefit of dying.

Today, the federal capital gain tax rate can be as high at 23.8% (the 20% top rate on long-term capital gain, plus the Affordable Care Act's 3.8% net investment income tax above threshold amounts). Married couples filing jointly with modified adjusted gross income above $250,000, and individuals with modified adjusted gross income above $200,000 are subject to the 3.8% tax. The threshold amounts are not indexed to inflation. A Maine resident subject to the top federal capital gain rate will also pay Maine income tax of 7.95% on the capital gain, resulting in a combined aggregate capital gain tax of almost 30%. There is no capital gain tax in New Hampshire.

An asset that passes to a traditional trust that was created at the first spouse's death for the purpose of reducing estate taxes, will receive a cost basis based on the value of the asset at the time of the first spouse's death. The cost basis will not change when the surviving spouse dies and the trust assets are distributed to the children as the remainder beneficiaries of the trust – the trust assets do not receive a stepped-up basis at the second spouse's death. Only assets included in the taxable estate of the surviving spouse receive a step-up in cost basis at the surviving spouse's death, and assets in a traditional Family/Bypass/Credit Shelter Trust are, by design, not included in the surviving spouse's taxable estate.

If the assets don't experience much appreciation between the time of the first spouse to die and the time of the surviving spouse's death, the difference in the income tax burden to the remainder beneficiaries, based on whether the assets receive a step-up in cost basis at the second death, may be insignificant. But, if several years pass between the spouses' deaths, and the assets have enjoyed substantial appreciation, the income tax burden differential may be great.

The decision of whether an asset should be distributed outright to the surviving spouse, or should be held in trust will depend on a number of factors: (a) if the surviving spouse owns the asset outright, will the surviving spouse's estate be large enough to subject the asset to state estate tax? Will it be large enough to subject the asset to federal estate tax? (b) will the children likely sell the asset, or are they likely to hold on to it for their lifetimes? (c) is there unrealized capital gain associated with the asset? (d) what is the likely tax rate for the children inheriting the asset at the surviving spouse's death - are they in a zero capital

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gain tax bracket, and do they live in a state with a state income tax? (e) if the asset is distributed outright to the surviving spouse, is there a risk that the surviving spouse will do something that wasn't intended by the first spouse to die . . . for example, leave the asset to a new spouse, or to the surviving spouse's children from a prior marriage?

If the choice is purely one of minimizing the tax burden to a couple's children and the asset has appreciated greatly, the answer may be easy: for a Maine resident, paying an 8% Maine estate tax will be preferable to paying a combined federal and Maine capital gain tax of roughly 30%. For New Hampshire residents, the dilemma doesn't come into play unless the value of the estate is over the federal estate tax exemption amount and is subject to the 40% federal estate tax, in which case paying a federal capital gain tax will be preferable to paying federal estate tax. On the other hand, having the children pay capital gain tax will always be preferable to paying the federal estate tax of 40%, plus a 10% or 12% Maine estate tax for a Maine resident if the estate is large enough to be subject to federal estate tax.

The lesson: estate planning documents should be flexible enough to permit a trustee to make the best decisions for the family, taking into account all relevant factors at the time, many of which could not have been known or anticipated by the first spouse to die. At the planning stage, consideration should be given to two options – authorizing the trustee (or perhaps a special independent trustee) to distribute certain assets from the trust to the surviving spouse to permit the assets to receive a step-up in cost basis at the surviving spouse's death, and authorizing the trustee to give the surviving spouse a power that will result in all of the trust assets being included in the surviving spouse's estate, which will result in a step-up in cost basis for all the trust assets.

The dilemma of which tax to pay is not a new one, but the recent combined effect of the increase in the federal estate tax exemption, portability of the federal exemption, and the increase in the effective capital gain rate plus the new net investment income tax, exacerbate the consequences of picking the wrong poison.

Gametes and Zygotes

"The time has come," the Walrus said,
"To talk of many things:
Of shoes – and ships – and sealing wax –
Of cabbages – and kings –
And why the sea is boiling hot –
And whether pigs have wings."

- *The Walrus and the Carpenter,*
Lewis Carroll (1832 - 1898)

When dinosaurs roamed the earth there was only one way to conceive a child (we know – please don't call to tell us that humans didn't share the earth with dinosaurs – go with us here – it's called artistic license).

Now, thanks to the advances of modern science, there are multiple ways to conceive: a woman is artificially inseminated with "genetic material" from her partner; a woman is artificially inseminated with sperm acquired from a third party donor; a genetic bank, through in vitro fertilization, creates a zygote (the predecessor of the embryo) either from a couple's own egg and sperm (each of which is a gamete) or from the egg and sperm of one of them matched it with the egg or sperm of a third party donor, or creates a zygote from the sperm and egg of two third-party donors, and implants the zygote in the woman's womb; a genetic bank creates a zygote using any of the above combinations and the couple has the zygote implanted in the womb of a gestational carrier (a woman who gives birth to a child under a gestational agreement, but has no genetic connection to the child), who agrees to carry the child to term in her womb, then give the child to the couple who hired her to be the gestational carrier; or, a couple may enter into an agreement with a surrogate carrier - a woman who gives birth to a child under a gestational agreement, but unlike a gestational carrier who has no genetic link to the child, does have a genetic connection to the child . . . she supplies her own egg. And, of course, these combinations are available to unpartnered individuals who desire to be a parent, and to same sex partners, whether married or unmarried.

While scientists and researchers were busy creating advances in artificial reproductive technology, the law lagged behind, and now, as is often the case when law and science meet, law is scrambling to catch up. For purposes of family law and inheritance rights, many questions are created by the advances in artificial reproductive technology. When is a parent-child relationship created? When is a child considered the child of a parent, and when is a parent considered the parent of a child? When does one have the right to inherit from the other?

Another implication of assisted reproductive technology: current law in most states, including Maine and New Hampshire, addresses the rights of children, as heirs, who are conceived before, but born after, the death of a parent. When the Maine and New Hampshire Probate Codes became effective, there was no conception (pun intended) of the possibility of a child being conceived after the death of a parent. With long-term storage of banking genetic material, what are the inheritance rights of a child posthumously conceived? For example, before undergoing radiation treatment for testicular cancer or heading to a war zone, a man banks his genetic material. He then dies. At the time of his death he was a beneficiary of a trust created by his parents. The trust provisions direct that at his death the trust terminates in favor of his children. He is survived by two children. Three years after his death, his widow decides to have herself inseminated with her deceased husband's banked genetic material. Is the child born from the use of that genetic material a beneficiary of the trust created by the man's parents? At what point after the man's death may the trustees of the trust safely distribute the trust assets to the man's children without concern that another child will be added to the class of beneficiaries who are entitled to share in the trust?

This year the Maine legislature will consider an update to the Maine Probate Code to adopt a comprehensive new statute that addresses the issues created by advances in artificial reproductive technology. There is no similar statute currently pending in the New Hampshire legislature.
Gone are the days of what we once knew as the traditional American family consisting of two married opposite sex parents and their children. As we've noted each year in our Estate Planning Year In Review, change is a constant. The law is doing its best to keep pace.

The Federal Gift and Estate Tax

> *"The avoidance of taxes is the only intellectual pursuit that still carries any reward."*
>
> \- John Maynard Keynes (1883 - 1946)

As of January 1, 2015 the gift and estate tax exemptions are "unified" at $5.43 million, an inflationary increase from $5.34 million in 2014. The tax rate on assets over $5.43 million is a flat 40%. The consequence of the unified gift and estate tax exemptions is that a person may use his or her exemptions during lifetime or on death to transfer assets to recipients without payment of a transfer tax. The generation-skipping transfer tax exemption remains tied to the gift and estate tax exemptions, and also increases to $5.43 million as of January 1, 2015.

On January 1, 2013 the annual federal gift tax exclusion amount increased from $13,000 to $14,000 and remains unchanged at $14,000 for 2015. The annual gift tax exclusion permits a person to give $14,000 a year to as many recipients as desired, without eroding the current $5.43 million federal gift and estate tax exemption. Payment of tuition and certain medical expenses are not subject to gift tax and may be made in addition to the annual gift tax exclusion of $14,000.

The annual gift tax exclusion for gifts to non-U.S. citizen spouses increased to $147,000 (from $145,000 for 2014).

Neither Maine nor New Hampshire has a separate gift tax, but gifts made within one year of death are included in the calculation of the Maine estate tax.

State of the Estate Review

"The line, it is drawn, the curse, it is cast
The slow one will later be fast
And the present now will soon be the past
The order is rapidly fading
The first one now will later be last
For the times, they are a-changin"

- The Times They Are a-Changin',
Bob Dylan (1964)

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.

We pride ourselves in helping you explore the options available to creatively and efficiently meet your planning goals, but you must take responsibility for reviewing your estate planning documents from time to time to ensure they aren't frozen in a time warp of personal goals and tax laws that no longer exist. What made sense to you when you created or last updated your estate planning may not make as much sense today.

The frequency with which you update your estate plan is left to your discretion. However, if it has been several years since you updated your plan, we encourage you to call to schedule a State of the Estate Review of your existing estate planning documents and discuss updates appropriate for both tax and non-tax reasons. Absent your request to schedule a State of the Estate Review, we will not review or update your estate plan to reflect changes in the law or for other purposes.

We promise to do our best to keep it simple.

No One Does It Better

David Backer and John Kaminski were both recognized this year by Super Lawyers and/or Best Lawyers in America for their work in trust and estate planning and probate, and John was also recognized for his skill in tax and real estate law. In addition, David was named as the Portland estate planning Lawyer of the Year for 2015 by Best Lawyers.

David and John are both elected Fellows of the American College of Trust and Estate Counsel. A lawyer cannot apply for membership in the College. Fellows of the College are selected on the basis of professional reputation and ability in the fields of trusts and estates.

David continues to serve as a member of Maine's Probate and Trust Law Advisory Commission created by the Maine legislature, and has served as Chair of the Commission since its creation in 2009. The Commission, made up of lawyers and judges, is charged with conducting a continuing study of the probate and trust laws in Maine and making recommendations to the Legislature for how those laws may be improved.

Jessica Scherb was named a Rising Star in the fields of estate planning and probate. She's a superbly talented lawyer and is truly a rising star, deserving of the recognition. Rising Stars are selected by our peers as the best attorneys no

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more than 40 years old, or who have been practicing for 10 years or less.

When disputes arise in estate and trust administration, we look to **Dave Sherman**, the chair of our Trial Services Group. Dave has extensive experience resolving estate and trust disputes in the Maine courts and has been repeatedly recognized by Best Lawyers and Super Lawyers for his litigation skills.

Chris Stevenson, a lawyer and certified public accountant, was named a Rising Star in tax law and in employee benefits/ERISA law. We regularly turn to Chris for input on income tax issues inherent in trust and estate planning and administration.

David, John, Jessica, Dave, and Chris are representative of the thirty-six lawyers at Drummond Woodsum who were recognized by Super Lawyers and/or Best Lawyers in America in 2014 for their work in a broad array of legal practice areas.

Thank You for Your Trust

We take seriously the trust you place in us and will continue to do everything possible to continue to earn your trust.