

Estate Planning in the Face of Changing Estate Tax Laws

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All too often, young attorneys are presumed to know as much about the law as our seasoned colleagues. “You went to law school, right?” is a common question we all hear. In many instances, such presumptions can be overwhelming to a young attorney trying to prove his or her worth to partners, clients, friends, and family alike.

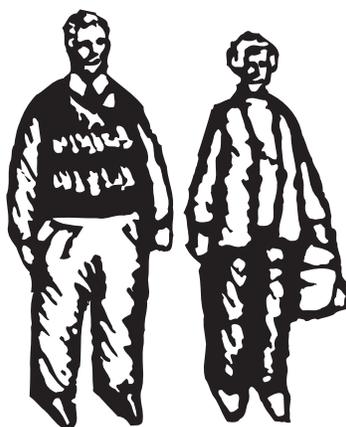
Questions about estate planning, in particular, are common from family members and friends. Attorneys often see the preparation of a Last Will and Testament as a simple drafting process using form documents. However, to the extent that you have incorporated estate planning as a regular part of your practice and are more cognizant of the many pitfalls of estate planning, recent changes in the law require all practitioners to tread carefully in this area. This article is intended to provide young attorneys with guidance regarding recent and ongoing changes to the federal and state estate tax laws that significantly affect how you plan for your client, family member or not.

In preparing an estate plan, it is important that you plan for death and disability in a manner that is both consistent with your client’s goals and flexible enough to appropriately handle changes in the law as well as your client’s personal situation. At a minimum, each estate plan should have the following documents:

a. Power of Attorney – A disability planning document that appoints an individual to make financial based decisions. A detailed discussion of Powers of Attorney is outside the scope of this article, but you should be aware of recent

changes in Maryland law (MD Code Est. and Trust § 17-101 et seq.). -- and --

b. Advance Medical Directive/Living Will – A disability planning document that appoints an individual to make health related decisions and provides specific direction regarding end of life care. Again, a



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discussion of drafting tips is outside the scope of this article, but the Maryland sample form is available at <http://www.oag.state.md.us/Healthpol/adirective.pdf> and MD Code Health General § 5-601 et. seq. -- and --

c. Last Will and Testament – The primary document handling distribution of assets at death and appointment of personal representatives and trustees of testamentary trusts, if applicable. The Will governs distribution of all probate assets (namely, all assets owned by

a decedent except those assets held jointly with rights of survivorship or that pass pursuant to a beneficiary designation). -- and/or --

e. Revocable Living Trust – A Will substitute which similarly handles distribution of assets at death, but in a manner that is intended to avoid probate and provide additional disability planning protections. This document is used in conjunction with a “pour-over” Will that directs any assets not already titled in the name of the Revocable Trust during life to a Revocable Trust upon the death of the grantor.

This Article focuses on the impact of recent changes in estate tax law on the preparation of Wills and Revocable Trusts. Specifically, it discusses changes in the laws of both Maryland (now several years old) and the federal government (passed in December 2010) that affect planning for the distribution of a client’s assets.

Estate Tax, Generally— In general, every dollar transferred at death is subject to estate tax. There are several important exceptions to the application of the estate tax, the two main exceptions being:

1. Unlimited tax-free distributions to the surviving spouse; and
2. Tax-free distributions to non-spouse beneficiaries, up to set federal and state estate tax exemption amounts (see chart below).

How We Planned for the Estate Tax, Traditionally— In planning for estate taxes, the first line of defense is to ensure that estate tax exemptions

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for both spouses are fully utilized. Until a recent change in the federal tax laws allowing for portability, a simple Will or Revocable Trust that provided for outright distribution to a surviving spouse, or that titled assets jointly between spouses with rights of survivorship, failed to accomplish this goal. Assets would pass to the surviving spouse undiminished by estate taxes; however, upon the death of the surviving spouse, only the surviving spouse's exemption amount could apply to the combined assets. Accordingly, estate planning routinely used Credit Shelter Trusts (or Bypass Trusts), in which assets in an amount equal to the predeceasing spouse's estate tax exemption were placed in trust for the benefit of the surviving spouse, thus preserving the value of the predeceasing spouse's exemption while allowing the surviving spouse to benefit from the assets themselves. Traditional estate planning documents provided for the funding of a credit

shelter trust based on a mandatory formula-based provision with reference to the federal estate tax exemption.

Changes in Estate Tax Laws— Significant changes to federal estate tax laws began with the passage of The Economic Growth and Tax Relief

In addition to tax planning, you must make sure that your client's estate plan adequately meets his or her goals for distribution, fiduciary appointments, disability planning, asset protection, and administrative simplicity.

Reconciliation Act of 2001 ("EGTRRA"), which called for an increasing federal estate tax exemption amount and a decreasing federal estate tax rate for assets in excess of the federal estate tax exemption. Prior to the passage of the EGTRRA, Maryland residents were entitled to a state estate tax credit calculated on the amount of the federal estate tax. As the federal

estate tax exemption increased, taxes payable to both the federal government and the State of Maryland were decreased or eliminated.

As a result, in 2004, Maryland "de-coupled" from the federal estate tax calculation and capped its state estate tax exemption at \$1 million ("M"). This means that an individual may now be able to transfer assets at death completely free from federal estate taxes, but still have Maryland estate tax liability. Based on this decoupling, the traditional formula-based funding provisions for Credit Shelter Trusts may now result in Maryland estate tax liability for the difference between the federal estate tax exemption and state estate tax exemption at the death of the predeceasing spouse. (see chart below).

Use of the Maryland Q-Tip Trust— To alleviate liability under this Maryland-only estate tax on a surviving spouse, Maryland now allows married couples to defer the Maryland estate tax on the differential between the federal and Maryland estate tax

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YEAR	FEDERAL ESTATE TAX EXEMPTION	FEDERAL ESTATE TAX RATE	MARYLAND ESTATE TAX EXEMPTION	MARYLAND ESTATE TAX RATE MAX	TAXABLE AMOUNT
2002	\$1,000,000	50%	-	-	-
2003	\$1,000,000	49%	-	-	-
2004	\$1,500,000	48%	\$1,000,000.00	16%	\$64,400.00
2005	\$1,500,000	47%	\$1,000,000.00	16%	\$64,400.00
2006	\$2,000,000	46%	\$1,000,000.00	16%	\$99,600.00
2007	\$2,000,000	45%	\$1,000,000.00	16%	\$99,600.00
2008	\$2,000,000	45%	\$1,000,000.00	16%	\$99,600.00
2009	\$3,500,000	45%	\$1,000,000.00	16%	\$229,200.00
2010	\$5,000,000 or \$0 ¹	35% or 0%	\$1,000,000.00	16%	\$391,600.00
2011	\$5,000,000	35%	\$1,000,000.00	16%	\$391,600.00
2012	\$5,000,000	35%	\$1,000,000.00	16%	\$391,600.00
2013	\$1,000,000	55%	\$1,000,000.00	16%	-

¹-Based on recent federal legislation 2010 estates can elect can be made to have no federal estate tax with an unlimited exemption and a limited step-up in basis (per EGTRRA provisions), or a \$5 M exemption and a full step-up in basis. The taxable amount listed above for 2010 reflects the Maryland tax on \$4 M (the difference between the \$1 M Maryland exemption and the \$5 M federal exemption).

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exemption amounts until the death of the surviving spouse, through a Maryland Q-TIP election under MD Code Tax General § 7-309. In light of the de-coupled Maryland estate tax and the ability to defer Maryland estate tax until the death of the surviving spouse, it is now advisable to create two Trusts: one to hold the amount that is free from both Maryland and federal estate tax (presently \$1 M) and one to hold the remaining balance of an individual's federal estate tax exemption (presently up to \$4 M) to which a Maryland Q-TIP election will be applied following the death of the predeceasing spouse.

In addition to Maryland Q-Tip elections, the use of disclaimers to fund Credit Shelter Trusts can provide additional flexibility to account for future changes in estate tax law. Although the use of disclaimers requires adherence to strict guidelines upon the death of a predeceasing spouse, including a deadline for use of nine months from the predeceasing spouse's death and a prohibition against the surviving spouse accepting the benefit of the disclaimed assets, disclaimers can be a beneficial tool in estate planning.

Although use of Maryland's Q-TIP elections has been recommended for several years, many people still have old mandatorily-funded Credit Shelter Trusts that could inadvertently create a Maryland estate tax liability upon the death of the predeceasing spouse. Such formula-based funding, which defers to the federal estate tax exemption amount, should be updated to properly account for the Maryland estate tax.

Recent Changes in Federal Estate Tax Laws— On December 16, 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthori-

zation, and Job Creation Act of 2010, which was signed into law on December 17, 2010. This legislation "patched" federal estate and gift tax laws for two years by temporarily increasing the federal estate and gift tax exemption amount to \$5 M and decreased the federal estate and gift tax rate to 35%. In addition, this legislation attempted to avoid necessitating complicated estate tax exemption planning by allowing a surviving spouse to utilize a predeceasing spouse's unused estate tax exemption (portability) without the need for a trust.

Although these changes are generous, they do not eliminate the need for a Credit Shelter Trust, as: (1) the changes do not eliminate the need to

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shelter a predeceasing spouse's Maryland estate tax exemption, as Maryland does not presently provide for portability; (2) there is no portability for the federal Generation Skipping Transfer (GST) tax; (3) unlike the use of a Credit Shelter Trust, which provides continued estate tax exclusion on all appreciated assets from the death of the predeceasing spouse to the death of the surviving spouse, portability does not protect against estate taxes on any appreciation of assets once those assets are transferred to the name of the surviving spouse; (4) Credit Shelter Trusts continue to be a useful tool for asset protection and provide control over

the eventual distribution of assets upon the surviving spouse's death; and (5) the portability option expires at the end of 2012, absent further action by Congress. Finally, it is important to note that the increased exemption amounts are only temporary, with reversion to a \$1 M federal estate and gift tax exemption amount set to occur in 2013 (although political rhetoric points to a likely reversion to a \$3.5 M exemption).

Conclusion/Planning with Today's Federal and State Estate Tax Laws— The foregoing discussion recommends that flexibility is the key to a solid estate plan. Assuming you incorporate flexibility in your planning, changes to federal and state estate laws, such as the recent change to the federal estate tax laws in December, 2010, are less likely to require updating of your client's estate planning documents.

The above-mentioned Maryland Q-TIP planning is still the recommended strategy, as it provides flexibility in your documents, which remains of utmost importance in light of ever-changing federal and Maryland estate tax laws. Keep in mind, however, that tax planning is only one part of a client's Will or Revocable Trust, and only one part of a client's overall estate plan. In addition to tax planning, you must make sure that your client's estate plan adequately meets his or her goals for distribution, fiduciary appointments, disability planning, asset protection, and administrative simplicity. ❖

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