

GOOD NEWS ON FEDERAL ESTATE TAX, BUT POSSIBLE SIDE EFFECTS

Estates & Trusts Alert
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The federal estate tax exemption increased to \$3.5 million on January 1, 2009, and the Obama administration says it favors making that change permanent. This is good news. It means that with proper planning, a married couple with assets of \$7 million or less should not pay any federal estate tax. And, if the moving pieces of recent tax law really do come to rest — at least as much as the tax code ever comes to rest — long-term planning will again be possible.

The much higher federal estate tax exemption — good news in itself — may cause unintended results, especially for people who live in New York and have an estate plan that includes a gift to the surviving spouse linked to the federal tax code by a formula. A typical formula gift would read as follows: “I give to my wife, if she survives me, the minimum amount that will reduce the federal estate tax payable by my estate to the lowest possible amount.” Probably 80 to 90 percent of Hodgson Russ clients’ estate plans follow this design, which has the advantage of adjusting automatically to changes in the federal law. Many 15- or 20-year-old wills are still effective in eliminating any federal estate tax until the surviving spouse’s death, but the higher federal estate tax exemption may have two types of unwanted side effects. First, it may result in a large New York tax bill on the death of the first spouse to die because New York’s exemption has remained at only \$1 million. Second, the higher exemption may unbalance an estate plan in other ways. Periodic review of estate plans is always a good idea and may be crucial now if you think any of the following examples apply to your estate plan or the allocation of your assets.

Example 1: A husband and wife have wills signed in 1998 that include a formula gift to the surviving spouse. The wife’s will, for example, gives her husband the amount necessary to reduce her federal estate tax to zero. The balance of her estate — the \$3.5 million now covered by the estate tax exemption — passes to a family trust (sometimes called a “credit-shelter” or “bypass”) trust because it bypasses the husband’s estate and escapes taxation on his later death. The family trust’s beneficiaries are her husband and their children. Assume that in 1998 the wife had \$1 million in an IRA (naming her husband as beneficiary) and \$3.5 million of other assets that will pass under her will. Assume also that in 2008 she has exactly the same assets — an assumption that might have seemed incredible until the recent economic collapse proved otherwise. In 1998, the federal estate tax exemption was \$625,000, so the formula gift under the wife’s will would have resulted in \$625,000

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going to the family trust and the rest of her estate (\$3,875,000) going to her husband. Because of the change in the tax law, in 2009 her husband has unrestricted access only to the \$1 million in the IRA. \$3.5 million goes into the family trust, of which he is only one of several beneficiaries and may not be a trustee. This unintended effect of the increased estate tax exemption may not be such good news to the husband.

Example 2: Now for the New York component. Assume the couple in example 1 lives in New York. The formula in their wills has adjusted automatically for the increase in the federal exemption, but the New York exemption remains what it was in 2002 — \$1 million. In 2009, the wife's estate pays no federal estate tax, but will owe \$229,200 in New York estate tax. (If the wife's estate were larger, a circular calculation could increase the New York tax to \$254,911.) This couple intended that no significant estate tax would be payable until they were both gone, but the different state and federal exemptions now thwart that intention. Unlike some states, New York does not permit its tax to be deferred through a state-only marital deduction. Practitioners have devised a stop-gap remedy that may defer or even avoid the New York estate tax otherwise due on the death of the first spouse to die, but it requires wills or revocable trust agreements to be revised so they create family trusts with special, flexible terms.

Example 3: Return to the couple in example 1, but now assume that this is a second marriage, and the husband is significantly younger. In 1998 they agreed that if the wife were the first to die, the husband would not need the \$625,000 exemption amount and also agreed that the wife's children by her first marriage should not wait to receive their inheritance until the younger husband's death. The wife's will therefore includes the same marital formula as in example 1, but leaves the balance of her estate to her children outright. Because of the increase in the estate tax exemption, in 2009 \$3.5 million now goes to the children, and the husband must get by with only the \$1 million IRA. This division of assets may be very far from what the wife intends or the husband needs. It may even result in litigation if the husband asserts his right under state law to receive a larger share of her estate.

Example 4: Now consider what happens to the couple in example 1 if the husband dies first, owning only a \$1 million IRA and a \$1 million life insurance policy. The wife is the beneficiary of both. This couple thus has total assets of \$6.5 million and should pay no federal estate tax because together they have \$7 million of exemption. But the IRA and the death benefit of the life insurance pass directly to the wife; nothing passes under the husband's will to the bypass trust. Thus, if the husband dies first, all of his \$3.5 million exemption is wasted. The wife's estate will be worth \$6.5 million (her own \$4.5 million plus his \$2 million), but she has only \$3.5 million of exemption. The result is an entirely avoidable tax of \$1,350,000. The wife might be able to reduce this cost — for example, by refusing to accept the IRA or the insurance proceeds — but this kind of post mortem remedy is seldom completely satisfactory. Under current law a spouse cannot transfer unused exemption to the surviving spouse. Legislation has been proposed to permit such transfers, but prospects for enactment are uncertain.

Example 5: A much simpler situation. A married couple live in New York and have total assets worth \$2 million, all held jointly with right of survivorship. The estate of the later to die will owe New York \$99,600 in estate tax. They could have saved all of that tax by taking two simple steps: dividing their assets equally between them, and having wills that avoid wasting estate tax exemption on the first death.

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If you would like to learn more about how this increase in the federal estate tax exemption may affect you, please contact your Hodgson Russ attorney or any member of our Tax Group listed below.

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