

Estate Planning 101

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If you own a home and some life insurance and are entitled to retirement plan benefits from work, your gross estate may already exceed the threshold at which estate tax liability begins. Since the top estate tax rate is 45% (no estate tax in 2010, and reverts to 55% in 2011), planning to make the best use of your exemption is essential.

In 2009 the first \$3.5 million of your taxable estate is exempt from federal estate tax (up from \$2 million in 2008). Your spouse is also entitled to an exemption of \$3.5 million.

The estate tax is scheduled to expire on January 1, 2010, but it is scheduled to be restored (with only a \$1 million exemption) on January 1, 2011. If the value of all assets owned by you and your spouse exceeds the exemption amount, an estate plan which results in the surviving spouse receiving all the assets will result in estate tax liability at the death of the second spouse. This, in turn, reduces the amount available for your children or other beneficiaries.

Often families are subject to estate tax because they failed to properly plan. In general, whatever assets are left to a surviving spouse are not subject to estate tax because of the marital deduction. There are no limits on the amount of the marital deduction. Thus, if your entire estate goes to your surviving spouse, your estate will owe no federal estate tax. Many taxpayers take this simple approach. In the long run, however, it can cost your family hundreds of thousands of dollars in extra estate taxes.

A married couple can escape estate tax on assets of up to two times the exemption amount (\$7 million in 2009) if the couple's estate plan is drafted to take full advantage of each spouse's own exemption. The most effective way of implementing this strategy is to set up a revocable living trust.

The trust should provide that, when the first spouse dies, the amount protected from estate tax (\$3.5 million) is allocated for the benefit of the surviving spouse. Your spouse can receive the income for life and your children can receive the assets at the spouse's death. Principal can be used for the surviving spouse's maintenance and support. These proceeds will not be included in the surviving spouse's estate at death. The following example (which uses the credit amount that applies in 2009) illustrates the tax savings that result from using a properly drafted trust instead of leaving the entire estate outright to the surviving spouse.

Assume you and your spouse have assets worth \$4 million and \$500,000, respectively. If you leave your entire estate outright to your spouse, there will be no estate tax at your death, because your \$4 million qualifies for the marital deduction in your estate. However, when your spouse dies, their estate includes the \$4 million inherited from you (assuming no intervening changes in wealth) plus their own \$500,000. Since your spouse is only entitled to leave to a non spouse \$3,500,000 without incurring an estate tax

(assuming death in 2009) \$1 million of the estate will be taxable resulting in a Federal estate tax of approximately \$675,000!

If, instead, your trust provided that an amount equal to the estate tax exemption (\$3.5 million) was allocated for the benefit of your spouse (from which your spouse and/or children would receive income and could have principal paid to them if they needed it), and the balance of your estate (\$500,000) passed outright to your spouse, there would be no estate tax due upon your spouse's death. There would be no estate tax due because your spouse's estate would only include the original \$500,000 plus the \$500,000 from your estate. Since the total assets in your spouse's estate was less than the exemption amount (\$3.5 million) there would be no estate tax upon the spouse's death.