

There's still a need to plan for the estate tax

As the debate in Congress over the repeal of the federal estate tax continues, the question is: What should you do about your planning in light of the current uncertainties?

The one thing that you should *not* be doing is sitting back and waiting. Full, immediate repeal is unlikely, meaning that planning remains in order. If some form of the tax stays in place, you want to make certain that you take maximum advantage of the available tools and techniques to minimize any tax that could be owed on your assets at your death (or the death of you and your spouse).

During the next few years, the federal estate tax will become focused more narrowly on the estates of the wealthy. This year the amount exempt from the tax is \$2 million. As it stands now, the exempt amount will continue to grow, and there will be no federal estate tax in 2010. (See “Exempt amounts rise, and top rates fall in the coming years” below for details.) However, as currently scheduled, in 2011 the estate tax is restored, and the exemption falls back to \$1 million.

The mistake that many couples make

Say that a husband and wife have assets worth an aggregate \$2.5 million. The husband dies, leaving his assets outright to wife. There's no estate tax at that time because of the tax shield provided by the marital deduction—for estate and gift tax purposes, a married couple is treated as a single taxpaying unit. But later, when the wife dies and leaves the combined estate to their children, only one estate tax exemption, hers, will be available to protect the family fortune. The husband's exemption has been lost, and a significant estate tax might have to be paid.

The amount of the tax exposure depends upon the year in which the wife dies. Should she die in 2009, there would be no additional estate tax, because the exempt amount that year is \$3.5 million. In 2010, of course, there will be no tax on estates of any size. But in 2011 and later years, a scant \$1 million will be protected, leaving \$1.5 million exposed to taxes at rates that will begin at 37%.

Fortunately, married couples do have a way to preserve both their tax exemptions. Through the use of “bypass trusts,” they can create legal and proper tax protections for their families.

How bypass trusts work

What is a bypass trust? It’s a trust, funded with no more than the amount exempt from federal estate tax, that provides the surviving spouse with lifetime income, yet bypasses the surviving spouse’s taxable estate.

A bypass trust can be created either by a married person’s will or through a living trust agreement. In either case the assets remaining in the trust at the death of a surviving spouse pass to designated beneficiaries—typically, the couple’s children—without being taxed as part of the survivor’s taxable estate. Thus, the survivor’s tax exemption can be used to shield other assets from tax.

For our hypothetical couple with \$2.5 million to protect, \$1.5 million could go into a bypass trust and \$1.0 million into a marital deduction trust. Only the marital deduction trust would be subject to future estate taxes, and so estate taxes could be brought down to zero.

Marital deduction trusts

The subject of drafting marital deduction trusts is a vast one. Here are three approaches with which the layperson should become familiar:

- **Power of appointment trust.** Surviving spouse has the right to all trust income, paid at least annually. Spouse has the right to determine the final trust beneficiaries in his or her will.

- **Qualified terminable interest property (QTIP) trust.** A surviving spouse has the right to all trust income, paid at least annually, but no right to change the final disposition of the trust assets. This approach often is used in second marriage situations when there are children from a first marriage to provide for. The QTIP deduction is elective and may be taken in whole or in part. Thus, the QTIP approach gives the executor (or personal representative) an added level of flexibility in shaping the estate plan after death for optimal tax efficiency.

- **Qualified domestic trust (QDOT).** The marital deduction is limited when the surviving spouse is not a U.S. citizen. However, the marital deduction may be claimed for a

trust that meets a number of special tax code requirements, including that at least one trustee be a U.S. citizen or domestic corporation.

If you and your spouse still are relying on simple wills for your estate planning, this may be a good year to look into taking some basic steps to improve your family's financial security.

Exempt amounts rise, and top rates fall in the coming years

Year	Exempt amount	Top estate tax rate
2006	2.0 million	46
2007	2.0 million	45
2008	2.0 million	45
2009	3.5 million	45
2010	No estate tax	No tax
2011*	1.0 million	55

*Under current law, after the federal estate tax is suspended for one year in 2010, it returns with higher rates and only a \$1 million exemption in 2011.

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Any developments occurring after January 31, 2006, are not reflected in this article.