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Client Newsletter
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SPECIAL CLIENT UPDATE EDITION:

Now, Not Even Death and Taxes Are Certain!

Married Couples with Pre-2002 Plans Need to Have Their Plans Reviewed Immediately in Light of Estate Tax Laws Beginning January 1, 2010

Please check the date of your estate planning documents to see if they are dated prior to 2002. Married couples with pre-2002 plans need to have their plans reviewed *immediately*.

Given the current situation with Congress and the state of the law, it may no longer be possible to tell how the trust or trusts will be funded post mortem beginning January 1, 2010. This could result in the imposition of a post mortem court proceeding in order to interpret the meaning of your trust agreement.

Another alternative might be for the State of South Carolina to enact special legislation, but none is in the works, nor is any such legislation anticipated. For these reasons, you need to protect your own interests by having any pre-2002 estate planning reviewed.

Although we have written about the potential for this issue in a number of newsletters, beginning as far back as May or June of 2001, the problem has in fact arrived and now must be addressed in order to prevent the potentially negative consequences for your surviving spouse and other family members. If you have ignored the issues in the past, please do not do so now. This may be the last train leaving the station.

What Caused the Problem?

As you may have heard, Congress failed to pass promised estate tax legislation to extend the current $3,500,000 exemption into 2010. This means that there is no estate tax beginning January 1, 2010. In theory, this sounds great, and for many of our clients, it may be. However, if nothing further happens, the estate tax *exemption* will only be $1,000,000 beginning January 1, 2011. With any luck, Congress will at least fix this part of the problem prior to 2011, but if the last nine (9) years are any indication, you certainly can not depend upon it.

There is also some discussion of Congress retroactively reinstating or continuing the $3,500,000 exemption sometime after January 1, 2010. Some commentators have hypothesized that

Congress could wait as late as September of 2010. However, there are significant arguments that this may be unconstitutional. Most would agree that it is unfair. The result is that we may have an estate planning mess on our hands.

We mitigated the issue beginning in 2002 by switching most clients to disclaimer trusts, which are designed to take care of the problem, unless Congress does something even more unusual and unexpected. ***This means, however, that married couples with pre-2002 plans, need to have their plans reviewed immediately. Otherwise, there may be unintended results at death. These are not just our clients; they are people all over the country.***

While there are many commentators talking, writing and blogging about the problems with the lack of Congressional action, virtually all of them are focusing on numerous other technical issues and have apparently buried their heads in the sand when it comes to the following questions:

"When a client dies with a pre-2002 formula marital deduction clause, what am I going to tell the surviving spouse about how much he or she is to receive and how much goes to each of the postmortem trusts?"

"Are all of the assets going to go into the more restrictive Trust B and what if the surviving spouse is not the only beneficiary of the trust?"

"Am I going to have to take the case before a judge to interpret it?"

"Am I going to have to see if I can get a settlement among family members who may or may not want to agree?"

"If I can get everyone to agree, do I have gift tax issues to deal with?"

These are by no means all of the questions, but they are among the more important ones to the surviving spouse and other family members.

What is the Pre-2002 Planning Problem?

The majority of United States married clients, who engaged in estate planning prior to 2002, have a variation of what is commonly referred to as a Trust A/Trust B plan; although it is also known by other names. The plan is based upon a formula that places an amount, based upon the date of death or possibly the alternate valuation date, into a Trust A and the remainder goes into a Trust B for the surviving spouse. There are also numerous variations of this formula that have developed over the years. Also, different jurisdictions and parts of the country often use different variations.

Most, if not all, of the assets in Trust B are designed to be non-taxable when the surviving spouse dies because the trust is not considered part of his or her taxable estate. Trust A was designed to qualify for the marital deduction upon the first death, thus causing the first estate not to be taxable, even if it were over the exemption amount. However, Trust A was taxable when the surviving spouse died, along with the survivor's other assets. Part of the planning also consisted of a proper balance between the estates of the spouses, to achieve the maximum estate tax savings.

Many clients elected this type of planning, especially with respect to Trust B, solely to save estate taxes. However, if the exempt amounts are great enough or there is no estate tax, which effective January 1, 2010 will be the case, there may be no estate tax savings to such a plan. This will be especially so for smaller estates and may include those under $3,500,000, or, if Congress brings in what is called portability, the amount may be up to $7,000,000, but again, Congress has not acted and we are not sure what they are going to do.

If these amounts do become law, they will cause the vast majority of Hilton Head estates to be non-taxable. Thus the Trust B, which has restrictions on the surviving spouse's right to access the assets, may become not only unnecessary, but also unduly burdensome on the surviving spouse. I hasten to add that we structured most of our Trust B plans for maximum flexibility, but numerous restrictions still apply.

However, the more serious problem with this pre-2002 Trust A/Trust B type of planning is that funding after the death of the first spouse is defined in terms relating to the federal estate tax and if there is no tax, then we may not know how much goes into either Trust A or Trust B under the terms of the trust agreement. For instance, these pre-2002 trusts contain language such as *"an amount equal to the maximum marital deduction allowable for federal estate tax purposes reduced to the extent necessary to create a zero estate tax after the application of the unified credit (applicable exemption amount)…"* when referring to how much goes into Trust A and how much goes into Trust B.

This language ties the amount going first, to the spouse or to Trust A, and then to Trust B, to federal estate tax definitions. ***When there is no federal estate tax, it is not clear how these clauses will be construed and how much goes into each trust or to the surviving spouse, if any; although, there is a strong argument that all the assets will go into whichever trust is the residual or residuary trust, assuming there is one.***

In a possible worst case scenario, the trust could fail and become a probate asset without a clear beneficiary or owner. In a somewhat more likely scenario, all the assets may go into the residual trust, if there is one. However, these are often of the more restrictive Trust B variety, which may or may not have been solely for the surviving spouse's benefit. In any event, the ambiguity presented by the current legislation or lapse in legislation may result in a court having to interpret your trust document, especially if there is any disagreement among the beneficiaries.

One solution to the problem is for South Carolina to adopt a statutory definition of what this means. They did exactly this back in the early 1980's when the maximum marital deduction for federal estate tax purposes increased from 50% of the adjusted gross estate to an unlimited amount. Unfortunately, nothing has been done by the legislature thus far to mitigate the problem, nor is anything in the works. Also, the numerous variations in these formula funding clauses, and not knowing the probable intent of the decedent, complicates such a solution and may make such a solution virtually impossible.

Another more likely solution, which is what we have consistently recommended, is to use a "disclaimer trust". A disclaimer resolves the problem because it starts by giving all assets to the surviving spouse in a very liberal Trust A. However, if the surviving spouse files a qualified disclaimer, the amount disclaimed goes into a Trust B for the surviving spouse's benefit, instead of Trust A. Trust B will then not be included in the surviving spouse's estate for estate tax purposes, if there is an estate tax. This type of planning allows the surviving spouse and his or her advisors to make the final determination up to nine (9) months after the death of the first spouse, based upon facts as they then exist.

The surviving spouse can disclaim *all or any portion of* the assets. This can add a great deal of flexibility to the postmortem planning process.

For the most part, the Trust A and/or Trust B created by disclaimer planning, can be very similar to the ones used in traditional Trust A/Trust B planning but without tying it to a formula based upon possibly non-existent estate taxes. The major distinction and exception is that with the Trust B using a disclaimer trust, the surviving spouse can not be given a special power to appoint assets, which allows the survivor to change the amounts going to beneficiaries after the surviving spouse's death. I hasten to add that many Trust B plans do not contain this provision, anyway. Of those that do, almost none of the powers are ever actually exercised. Although in many cases, such a right can be beneficial.

There are also some situations where a disclaimer trust should not be used and one very important situation is when a Qualified Terminable Interest Property Trust, called a QTIP Trust, is being used. These are trusts that are designed to take care of the surviving spouse but guarantee that what is left after the death of the spouse goes to children of the first spouse to die, yet qualifies for the marital deduction to save estate taxes, if there is an estate tax. This type of trust is mostly designed for second marriages with children from a previous marriage, when protecting the children is just as important as protecting the surviving spouse. Many of our clients have such trusts.

There are numerous other issues not discussed above that you will be hearing about in the news, which we will be working through on a case by case basis with our clients. **It is highly likely that we will have a workshop, as we have in the past, to discuss the issues and answer client questions.** ***In the meantime, we strongly suggest that you check our website for additional updates and information. The Internet address for the website is www.HiltonHeadEstatePlanning.com.***

We also have a section on our website where you can ask questions and we will try to answer them. However, try not to post any personally identifiable confidential information, since it can be read by anyone with Internet access, which at last count is about 7 billion people, worldwide.

Again, if you have a pre-2002 plan, we strongly recommend and encourage you to come in for a review and update. Also, even if you do not have a pre-2002 plan, you should consider coming in sometime in 2010, since there will be numerous other issues that we need to address.

If you want to set up an appointment to review your planning and documents, you can do either one of the following:

(1) Go to **www.HiltonHeadEstatePlanning.com** and download a package under the button labeled, "Returning Clients" and then call our office to set up an appointment, or

(2) You can call our office and we will email or mail the package to you and set up a convenient time to meet. As an alternative, we can also simply email you the direct link to the website download.

Also, please note that if your trust agreement was created or restated after January 1, 2002, we have already considered most of the issues and steps were likely taken to correct or mitigate many of the problems discussed above. However, if you have any doubts, you should come in to meet with us.

ANOTHER MATTER OF IMPORTANCE

Make Sure That You Reapply for Your Homestead Exemption and 4% Assessment Ratio if You Placed Your Home into Your Revocable Living Trust

For the first time in many, many years, we had a situation in which a client did not reapply for his homestead exemption and 4% assessment ratio soon after his real estate attorney prepared his deed transferring his primary residence into his trust. He only realized it when he received a tax bill on his home that was nearly 2½ times more than the previous year's bill.

Whenever we do trust planning and recommend that your house be placed into trust, we write to your real estate attorney and copy you on the letter to remind you that you should apply or reapply for the homestead exemption and 4% assessment ratio, if you otherwise are eligible. We also warn you of the risks of higher taxation, which have apparently become even greater with recent substantial increases in taxes that are being imposed locally and statewide, especially if the home is not a primary residence. In addition to our warning, most real estate attorneys will give you the same advice either orally or in writing.

If you have not done so, please apply or reapply prior to January 15, 2010, if you qualify. Otherwise, you will be paying a much higher tax than is necessary.