© 2013, All Rights Reserved

LEFKOFF, DUNCAN, GRIMES, MCSWAIN & HASS, P.C.

Optimum Marital Deduction Tax Planning

Where the value of the estate exceeds the amount of the estate tax exemptions available, appropriate provisions in each spouse's Will (and related trusts) can significantly reduce the impact of estate taxes on family wealth. For instance, in 2013 if the combined value of a couple's estate exceeds the $5,250,000 which is "protected" by the Unified Credit exemption, it may be important to optimize the use of the exemptions available in both estates.

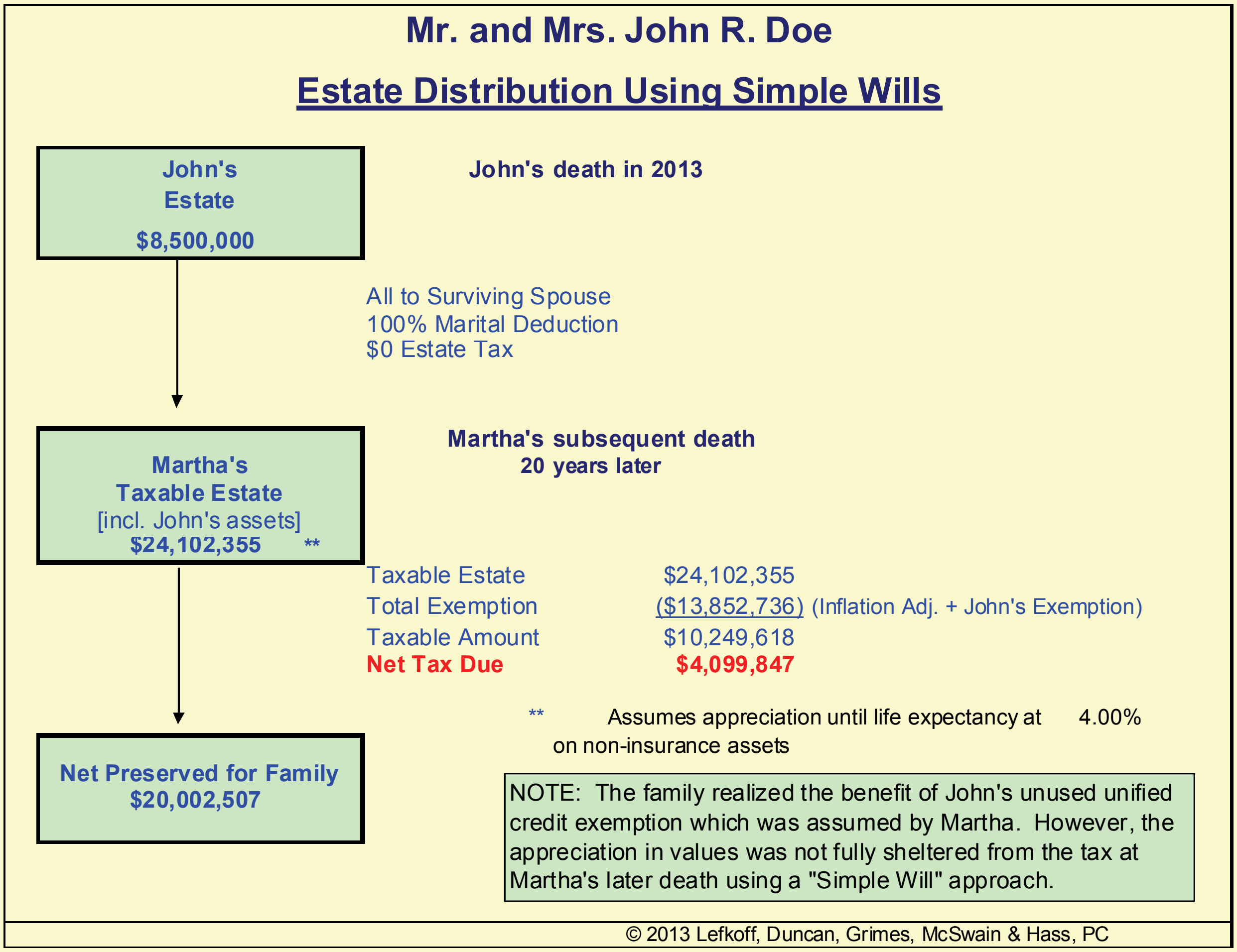
Prior to the 2010 Tax Act, the structure of the estate tax system led a taxpayer wishing to use a "simple" Will to waste one of the available exemptions entirely. If, for instance, John had died first and everything was left outright to his wife, Martha, there would have been no federal estate tax at John's death because everything would qualify for the marital deduction. However, all of this property would be taxable in Martha's estate at her later death, along with her other assets, with only her exemption available. The exemption amount which was otherwise available in John's estate would have been wasted. It was a "use it or lose it" rule.

After the 2010 Tax Act, the unused exemption of the first deceased spouse is "portable" and can be assumed by the surviving spouse (if proper elections are made.) Therefore, for persons who do not engage in estate planning to optimize the effective use of that exemption, the first deceased spouse's unused exemption can pass to the surviving spouse, who will be able to use the full amount in his or her later estate. For example, under the revised tax law, if John dies in 2013 with no effective tax planning in place, leaving his entire estate to surviving Martha, then there will still be no estate tax in John's estate (because of the marital deduction). However, if John's estate makes the proper elections, then upon Martha's subsequent death her estate will be able to use both her $5.25+ million exemption (adjusted for inflation) and John's $5.25 million unused exemption, for a total of $10.5+ million of exempt property.

Example. Assume that John and Martha Doe have combined total estates of $11,000,000, including $8,500,000 of asset value owned in John's name and $2,500,000 owned in Martha's name.

Using "Simple" Wills - Assume John dies first in 2013, at age 67, and leaves his entire estate of $8,500,000 outright to his wife, Martha, under a "simple" Will. There would be no estate tax due because of the marital deduction. We assume that John's executor files an estate tax return and makes the proper election, so John's unused $5,250,000 Unified Credit exemption is also transferred to Martha. Assume Martha dies 20 years afterwards, at her normal life expectancy, having preserved the principal of the property that John left her along with appreciation in value at the rate of 4% annually. For federal estate tax purposes, on Martha's death, the $8,500,000 of property left to her by John would be subject to the estate tax, along with her separate assets of $2,500,000, and appreciation for

20 years, for a total taxable value of $24,102,355. Martha's estate would use her unified credit exemption (assumed to have grown to about $8.6 million with the inflation adjustment) plus the $5,250,000 exemption which she assumed from John, to effectively cover the tax due on the first $13,852,736. The estate tax due would be $4,099,847.



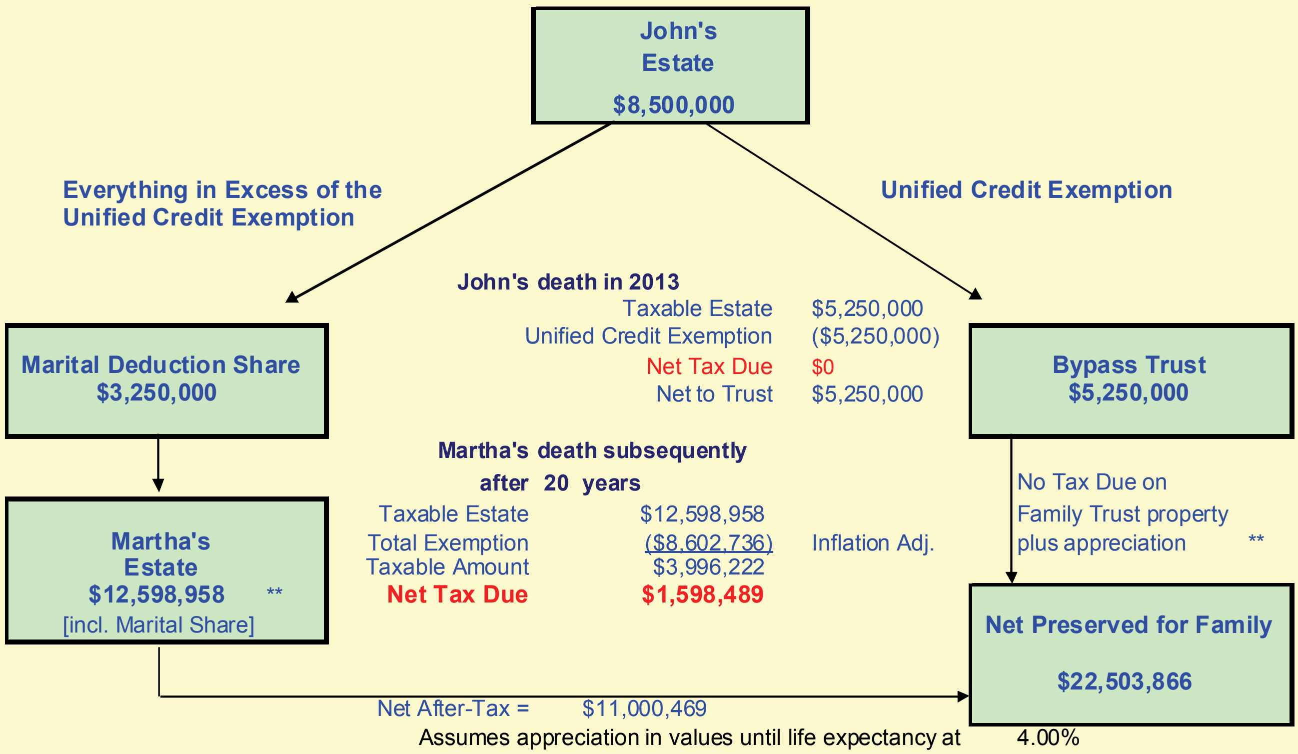
<u>Using "Optimum Marital" Wills</u> - If, however, John had used an "optimum" marital deduction plan, then on John's death, his unified credit exemption ($5,250,000 in 2013) would have been specifically used to fund a special "bypass trust" for Martha and the children.

That property would have been exempt from estate tax because of John's exemption, <u>and all future appreciation in value in the bypass trust would also escape estate tax</u>. The trust could also be completely exempt from the generation skipping transfer tax, so that future distributions to grandchildren would be tax free. In addition, that trust could authorize distributions of income to children and grandchildren, perhaps in their lower income tax brackets, rather than all income being taxed in Martha's tax bracket.

The balance of John's property ($3,250,000) would have been left to Martha (as with the simple Will) and would have been tax-free at John's death because it would have qualified for the federal estate tax marital deduction. Then, on Martha's death 20 years later, the $3,250,000 which Martha received from John as a marital deduction bequest would be included in her estate, along with her other property of $2,500,000, <u>and the appreciation</u> on those assets during her lifetime, for a total of $12,598,958, and we would utilize <u>her</u> Unified Credit exemption of $8,602,736 (inflation adjusted for 20 years.) The tax due on the balance would be reduced to $1,598,489. There would be no tax due on the property in the "bypass trust" because it was protected by John's Unified Credit and Martha would not be deemed to be the owner of the trust property for estate tax purposes (even though she may have been the primary beneficiary and trustee of the bypass trust.)

Mr. and Mrs. John R. Doe

Estate Distribution Using Optimum Marital Deduction Wills



NOTE: The family realized the benefit of John's Unified Credit Exemption in the Bypass Trust, which sheltered the full amount deposited in the trust plus all appreciation over Martha's lifetime. The exemption in John's estate was used to fund the Bypass Trust with the largest possible tax free amount of property. The remainder of John's estate is then left to the Marital Deduction Share for the sole benefit of his surviving spouse, Martha, for life. At Martha's subsequent death, her estate (including the property of the Marital Deduction Share which was received from John, and any appreciation in value) is subject to estate tax, AFTER using Martha's unified credit. The property remaining in John's Bypass Trust is still tax free (including any appreciation in value) and continues on for descendants without any estate tax. It is also exempt from generation skipping transfer tax.

NET SAVINGS = $2,501,359

© 2013 Lefkoff, Duncan, Grimes, McSwain & Hass, PC

As shown in the illustration above, the planned optimum use of John's unified credit exemption through the bypass trust, rather than relying on the new "portability" provision to leave his exemption to Martha, has preserved an additional $2,501,359 for the family. Note that this savings is achieved without sacrificing one of their primary estate planning goals - to leave the surviving spouse in charge of the entire estate. Martha can be the Trustee of the Bypass Trust even though she is also the primary beneficiary, with very few limitations, and anything needs to be done which Martha is not permitted to do, then she can be empowered to select and appoint a Co-Trustee who can exercise such powers.

The bypass trust can also allow Martha to "sprinkle" the trust income among the family members who need to consume it. Therefore, she can distribute trust income to her children and grandchildren, probably in much lower income tax brackets, rather than paying income tax on all of the income in her tax bracket.

In addition, using the bypass trust also preserves John's GST Exemption (see the article titled *Multi-Generation Planning* on this web site.) As a result, almost all of this estate can continue in the trust for the children and their descendants after John and Martha have died, so that it can be protected from risks arising in their lives from financial and business difficulties, and from marital discord.

Legal Opinion Disclaimer

and

IRS Circular 230 Notice:

The information provided herein is intended for general understanding only, is not a legal opinion on which anyone is authorized to rely for any purpose, and should not be applied to any individual's unique circumstances except through representation of competent legal counsel. Nothing herein is intended to establish an attorney-client relationship between Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. and the reader or any other person.

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.