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Estate Planning Tools for Married Couples

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INTRODUCTION

If you are a couple who has in excess of \$675,000 in assets, a hefty tax bill will often result after your death. Your intended heirs will be left with less of an inheritance and Uncle Sam will walk away with more of your money than you would probably like him to have.

Fortunately, there are estate planning techniques that can be utilized to reduce, or in some cases eliminate entirely, the estate taxes due upon your death.

The tax problem may not be present upon the death of the first spouse due to something called the marital deduction.

The IRS allows the decedent's estate to take a deduction from estate taxes for the value of any assets passing to the surviving spouse (with certain limited exceptions). Therefore, any assets that pass to the surviving spouse are estate tax free. This seems like a great solution; however a problem arises when the second spouse dies.

The second spouse now has a huge estate (due to the inheritance from the first-to-die spouse) and the accompanying huge tax bill. This outcome can be avoided by ensuring that each spouse gets to take advantage of their Unified Credit.

What is the Unified Credit?

In 2001, the government passed legislation exempting a certain amount of each person's estate from estate taxes. This exemption is called the Unified Credit. The amount of the Unified Credit changes every year according to the following schedule:

2008: \$2,000,000

2009: \$3,500,000

2010: no federal estate tax

2011: \$1,000,000

Therefore, if an individual dies in 2008 and he or she has less than \$2,000,000 in assets, there will

be no estate taxes due. If that person has more than \$2,000,000 in assets, then estate tax is only due on the amount in excess of that \$2,000,000. For example, if a person dies with \$2,500,000 in assets, that person's estate is only taxed on \$500,000. Each person gets their own Unified Credit, so in the case of married couples up to \$4,000,000 could be exempt from estate taxes in 2008 (\$7,000,000 in 2009, etc.) with careful estate planning. At the moment, the Legislature has not passed new estate tax legislation. It is therefore impossible to predict what the tax laws will be after 2011. This is just one reason why it is important to review your estate plan every year.

Estate planning is needed in the case of a medium sized or large estate because the marital deduction interferes with the first-to-die spouse's ability to utilize the Unified Credit. When estate taxes are calculated, all deductions (including the marital deduction) are taken before the Unified Credit is applied. When the first spouse dies and leaves everything to the survivor, it all passes via the marital deduction (with few exceptions). Since the deceased spouse's estate is essentially reduced to zero through the marital deduction, the Unified Credit does not come into play and is wasted. The surviving spouse now has a huge estate, and when he or she dies the remaining Unified Credit may not be enough to offset all the estate taxes due. In

other words, only one spouse will be able to make use of the Unified Credit.

With careful estate planning, both spouses will be able to utilize the Unified Credit and pass on more of their estates to their heirs tax free. Fortunately, there are several trusts that can be drafted into your will, either individually or in combination, that can reduce or eliminate any federal estate taxes that may be due upon your death. The most commonly used trusts are the Disclaimer Trust and the Credit Shelter Trust.

What is a Disclaimer Trust?

The disclaimer trust serves to hold assets in the estate of the deceased spouse so that the Unified Credit may be utilized effectively. It may seem counterintuitive to keep assets in the deceased spouse's estate at first glance; however, the tax consequences to the surviving spouse will be much less by doing so. The surviving spouse can disclaim an amount up to that of the Unified Credit into a trust set up by the will. That trust amount will remain in the deceased spouse's estate for tax purposes. However, the Unified Credit will exempt that amount from estate taxes. The surviving spouse will receive the income from the trust for life, and the trustee will be

able to use the principal for his or her support and maintenance if the need arises. The trust is then excluded from the surviving spouse's estate upon his or her death.

How the Disclaimer Trust works is best explained through the use of an example. Suppose a couple, Jack and Jill, has \$4 million in assets. Jack dies in 2039, and we'll assume that the Unified Credit amount for that year is \$1.5 million. Everything passes to Jill through a simple will, tax-free due to the marital deduction. Jack now has nothing left in his estate and therefore cannot use his Unified Credit. Jill dies later that year with an estate of \$4 million (because she now owns all of their assets after her inheritance from Jack). The first \$1.5 million is tax-free using her Unified Credit. However, the remaining \$2.5 million is subject to a 45% estate tax. Jill now has a tax bill of \$1,125,000.

Now let's say that the couple above each had a Disclaimer Trust set up in their wills. Jack dies. Jill disclaims \$1.5 million of her inheritance into the Disclaimer Trust and receives the rest of his estate through the tax-free marital deduction. Jack's estate is now \$1.5 million instead of zero, as it was above. Jack can use his Unified Credit of \$1.5 million to exempt his estate from taxes. Jill then dies later that year. However, the amount from the Disclaimer Trust is not included in her estate. Therefore, Jill now has an estate of

\$2.5 million, instead of \$4 million as in the example above. The Unified Credit will exempt the first \$1.5 million from Jill's estate, leaving only \$1 million subject to estate taxes. Jill's estate tax bill is now only \$450,000, a tax savings of \$675,000. Even though Jill still had estate taxes due, that amount was greatly reduced through the use of the Disclaimer Trust.

Obviously, the variables in the example above will change depending on the tax laws in effect at the time and the size of your estates at your deaths. However, the Disclaimer Trust will function in the same way. This type of trust is unique in that it gives you a great deal of flexibility. If your estates are small enough, or if the tax laws in effect at your death are such that the Disclaimer Trust is not needed, then the surviving spouse can inherit all of the deceased spouse's assets outright. The surviving spouse can also disclaim more than the amount of the Unified Credit if splitting the tax bill between the two spouses would be more beneficial.

The above example is tailored to avoid federal estate taxes. Since the exemption amount for New Jersey state estate taxes is only \$675,000, some state taxes may apply even though the federal taxes are significantly reduced. If it would be more beneficial to

reduce the state estate taxes instead, the Disclaimer Trust would allow the surviving spouse to disclaim the amount of the state tax exemption instead of the amount of the federal Unified Credit. The Disclaimer Trust is a unique estate planning tool because it allows you to wait and see what the most beneficial course of action will be before making a decision. This type of trust is useful for medium sized estates because at present it is harder to predict whether tax-saving tools will be necessary many years from now when the first spouse passes.

What is a Credit Shelter or Bypass Trust?

The Credit Shelter Trust, also known as a Bypass Trust, is essentially the same as a Disclaimer Trust, except that the option of whether or not to use the trust is taken away. With a Credit Shelter Trust, the trust is automatically funded up to the amount of remaining Unified Credit (or the amount of the state estate tax exemption if that is preferred) at the death of the first spouse. The surviving spouse does not have the option of choosing to inherit all the assets from the deceased spouse outright, and must take at least a portion of his or her inheritance through the Credit Shelter Trust.

This type of trust is useful for estates that are large because it is almost certain that tax saving tools

will be needed when the first spouse dies. Even though the surviving spouse's choice is taken away, this trust has its advantages. With a Disclaimer Trust, the surviving spouse must disclaim within nine months of the deceased spouse's death. This can be a very confusing and traumatic time, and there is a risk that the survivor may not disclaim within the allowed time period, or may not disclaim enough to render the trust fully effective. A Credit Shelter Trust will be automatically funded with the appropriate amount when the first spouse dies, and the survivor will not have the burden of making the decisions required by the Disclaimer Trust.

The disadvantage of the Credit Shelter Trust is that the surviving spouse will not get a large portion of the assets free and clear. This can be a problem when most of the assets in the deceased spouse's estate are illiquid (such as real estate, tangible items, or other property that is not money and/or does not produce income). The surviving spouse may not have enough liquid assets (actual money) with which to adequately support himself or herself. With a Disclaimer Trust, the surviving spouse has the option to take the assets outright if they are needed even though it may result in a higher tax burden in the long run.

CONCLUSION

For medium-to large-sized estates, a simple will is not enough to prevent the government from taking a large part of your estate in the form of taxes when you die. The Disclaimer Trust and the Credit Shelter Trust are two tax-saving tools that will allow you to pass on more of your assets to your loved ones upon your death. If your estate is larger than \$675,000 and you are interested in estate planning, please contact our office to discuss your options.

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