

The Estate Planning Advisor

Estate Tax Planning – The IRS Supermarket

By Richard J. Shapiro, J.D.

A thorough estate plan incorporates many concepts, and no discussion of estate planning is complete without addressing potential estate tax liability. The good news is that the federal estate tax exemption for an individual is \$3.5 million, which means relatively few estates are required to pay a federal estate tax. The bad news is that for those estates liable for federal estate taxes, the tax rate can be as high as 45%. New York State imposes its own estate tax on estates of \$1 million or more, although the tax rates are much lower rates than the federal tax rates.

As a result of poor planning, married couples often lose the estate exemption of the first spouse to die. The following story, which we call the “IRS Supermarket,” explains how the estate tax system applies to married couples.

Imagine that all Americans live in a mythical place called the IRS Supermarket. Consider a particular married couple with a net worth of \$5 million. Like most married couples, all of the couple’s assets – their home and other real estate, stocks, bonds, mutual funds, life insurance policies, annuities, etc. -- are either jointly owned, or the spouse is the primary beneficiary (e.g., IRA’s, 401k’s, life insurance). In our scenario, these assets are held in a single “shopping cart.”

Now imagine it’s time for the husband to “check out” of the IRS Supermarket. In his back pocket the husband keeps his “coupon” issued by the federal government, entitling the husband to exempt up to \$3.5 million of *personally owned* assets from the imposition of federal estate tax. However, because the couple’s assets are either jointly owned, or pass to the wife via beneficiary designation, the husband has virtually no assets to “scan” at the register and all the assets remain in the couple’s “jointly owned” shopping cart. While the husband’s estate will owe no federal estate tax at *his* death because his assets passed *directly* to his wife and were therefore exempt from federal (and state) estate tax due to the “unlimited marital deduction,” the couple has in fact lost a significant planning opportunity. The husband’s “coupon” has been effectively rendered worthless because there are no assets against which his estate can apply the coupon. By using the unlimited marital deduction, the tax attributed to the husband’s assets will not be eliminated, but will only be deferred until the wife’s death.

Imagine further that the wife, stricken with grief from her husband’s passing, “checks out” a month later owning all of the couple’s assets, which are still worth \$5 million. While she still has her own \$3.5 million coupon to apply against the \$5 million estate, her husband’s coupon is no longer available. As a result, her total federal and New York State estate tax bill is **\$890,000**.

Picture instead that the couple had put into place an estate plan in which the couple divided their assets roughly in half. The estate plan provided that, upon the first spouse's death, the deceased spouse's assets were to pass into a "credit shelter" trust. Under that scenario, the husband would be able to use his "coupon" to shelter his \$2.5 million of assets from federal estate tax, while the wife's \$2.5 million of assets would likewise be protected upon her death by the use of her own coupon. For New York residents, the total estate tax liability under our scenario can be limited to a New York estate tax of less than \$139,000, rather than a total tax bill of \$890,000. Further, depending upon the couple's goals and needs, the wife could be both the primary trustee and beneficiary of the credit shelter trust, having the ability to use the trust assets for her own needs and the needs of other family members.

The significant tax savings described above does not occur by accident. It requires that proper trust structures be created, and that the couple's assets be retitled to ensure that sufficient assets are available to "fund" the credit shelter trust upon the first spouse's death. Consultation with an estate planning attorney well versed in these issues is essential for a successful outcome.

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