



# Private Clients Alert<sup>®</sup>

## Legal and financial developments affecting individuals and their families

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### Estate tax changes and financial crisis create planning opportunities

- Estate tax and GST tax exemptions for 2009
- Discrepancies between federal and state exemptions
- Gift tax exemption and annual exclusion
- Low interest rates/low market values

As the old saying goes, what a difference a day makes! As the calendar changed from 2008 to 2009, major changes occurred in the rules related to gift and estate taxes that may significantly affect your estate planning. You should be aware of these changes and also be alert to some extraordinary economic circumstances that make various planning strategies especially advantageous at this point in time.

#### **Estate tax and GST tax exemptions for 2009**

As you know from past discussions with us, the estate tax exemption amount (which is the amount you can pass free of federal estate tax to whomever you choose) has been increasing in stages over the course of the past several years. In fact, from 1999 through 2008, the exemption increased from \$650,000 to \$2 million, and now, for 2009, the exemption is \$3.5 million. Remember that the exemption is available to every individual, so for married couples, that means as much as \$7 million can now pass free of federal estate tax.

Preliminary signals from the new Congress and the Obama administration indicate that the estate tax will not be allowed to lapse (as it is presently slated to do in 2010), but will be continued indefinitely, with at least a \$3.5-million exemption amount. While this substantial increase is certainly welcome news, it could have unanticipated and unintended consequences in your personal estate plan.

Consider this very typical scenario: Sam's will provides that, upon his death, part of his estate is to pass into a "credit shelter trust" for the benefit of his wife, Susan, and the balance of his estate is to pass outright to Susan. The amount that is to fund the credit shelter trust is based on the exemption amount. Let's assume that, at the time Sam's will was drafted, the exemption amount was \$1 million and the total value of Sam's estate was \$3.5 million.

Thus, Sam thought that, when he died, \$1 million would be held in a trust for Susan's benefit and the \$2.5 million balance of his estate would pass to Susan outright. Now, however, with the increase in the

exemption amount to \$3.5 million, Sam’s entire estate will pass into the trust and nothing will pass to Susan outright—not what Sam had intended.

The situation could be even worse if Sam had structured his will so that, instead of an amount equal to the exemption passing into a trust for his wife, that same amount was to pass outright to Sam’s children, with the balance passing to Susan. With the change in the exemption to \$3.5 million, the children would receive Sam’s entire estate (although Susan might be able to claim her “elective share” of Sam’s estate under state law).

### **What about “disclaimer trusts?”**

If your current plan no longer meets your needs because it uses a formula linked to the amount of the estate tax exemption, a potential “fix” may be found in a “disclaimer trust.” Federal and state law allow a beneficiary to refuse to accept (disclaim) all or a portion of a bequest. Rather than using a formula to direct the amount of credit shelter trust funding, wills may be structured to leave the entire estate to the surviving spouse outright, with the provision that any property disclaimed by the spouse will be used to fund the credit shelter trust. This approach allows the surviving spouse to make tax-planning decisions based on knowledge of the then-existing tax laws and the size of the overall estate, and to tailor the size of the credit shelter gift accordingly. While a very flexible approach, the disclaimer relies upon the good sense and active decision-making of the surviving spouse and may not be an appropriate strategy in all circumstances (i.e., second marriages or spouses who may be aged or infirm).

Similar to the estate tax exemption, there is also an exemption from the “generation-skipping transfer tax” that could apply to gifts or bequests to grandchildren. The amount of the GST tax exemption has also now increased to \$3.5 million. Again, the potential exists for unwittingly making a bequest that is much larger than what was contemplated.

The point is that many wills and revocable trusts are drafted with bequests tied to a formula linked to the amount of the estate tax exemption or the GST tax exemption. With the dramatic increases in the exemption amounts, the documents may no longer convey the person’s true intent. If your will or revocable trust includes this type of a gift, you may want to reconsider your plan.

### **Discrepancies between federal and state exemptions**

We should also point out that, although the federal estate tax exemption has increased significantly, some states like New York and Massachusetts have exemptions fixed at \$1 million. This “disconnect” between the federal and state exemption amounts can have unintended consequences—

particularly the state tax that would be payable on a bequest linked to the federal exemption. For example, a New York decedent whose will provided for the creation of a credit shelter trust funded with an amount equal to the federal exclusion amount would incur a New York estate tax of \$229,200—the tax on the difference between the \$3.5-million federal exclusion and the \$1-million state exclusion. A Massachusetts decedent faces the same potential estate tax of \$229,200, but under Massachusetts law, with proper drafting, this state estate tax can be deferred.

Florida and New Hampshire presently have no state estate tax.

### **Gift tax exemption and annual exclusion**

The “gift tax annual exclusion amount” also changed with the turn of the calendar. Beginning in 2009, you can now give up to \$13,000 each to an unlimited number of people without gift tax consequences.

In addition, you can still pay tuition and medical expenses in any amounts without those payments being considered taxable gifts.

Speaking of lifetime gifts, remember that, if you do make gifts in excess of the annual exclusion amount, you will not actually need to pay gift tax until your cumulative taxable gifts exceed the gift tax exemption amount which remains at \$1 million.

### **Low interest rates/low market values**

A goal of many of our clients is to transfer as much of their wealth as possible with little or no gift or estate tax payable. To help achieve that goal, we use a variety of planning strategies, some of which are more effective when interest rates are low. These strategies include the use of intra-family loans, “grantor retained annuity trusts,” “sales to intentionally defective grantor trusts,” and “charitable lead annuity trusts.” With current interest rates at historic lows, we are urging our clients who would like to transfer more substantial amounts to their heirs to take advantage of the situation—it may not last long.

Similarly, and although it may seem counter-intuitive, the drubbing many of us have taken in the financial and real estate markets has presented a favorable time for gifting. A simple example may best make the point. A year ago, you may have had 1,000 shares of XYZ stock available to give to your child. At the time, those 1,000 shares were worth \$20,000, so, if you had given all 1,000 shares, you would have made a taxable gift of \$8,000 (the difference between the value of the stock and the then-prevailing \$12,000 gift tax exclusion). Now, however, because of the downturn in the market, those same 1000 shares are worth only \$13,000 and you can proceed to give the shares without worrying about the gift tax.

Obviously, this same reasoning can be extended to larger gift amounts, right up to the \$1-million gift tax exclusion. Consider gifting assets while their value is low and allow future appreciation to occur in your beneficiary’s account, rather than yours. Of course, as you contemplate any lifetime gifts, remember to include income tax ramifications in your deliberations.

We would be happy to talk with you at greater length about these or any other estate planning issues you may have in mind.

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For additional information or advice, please feel free to call or e-mail your Nixon Peabody advisor the Private Clients team members listed below ([e-mailname@nixonpeabody.com](mailto:e-mailname@nixonpeabody.com)).

### PARTNERS

Deborah L. Anderson, Esq.  
Sarah T. Connolly, Esq.  
Cressida A. Dixon, Esq.  
Thomas M. Farace, Esq., CPA, CFP<sup>®</sup>  
John T. Fitzgerald, Jr., Esq.

John L. Garrett, Esq.  
Evelyn V. Moreno, Esq.  
Patrice B. Morrison, Esq.  
Stephen M. Newman, Esq.

G. Joseph Votava, Jr., Esq., CPA/PFS, CFP<sup>®</sup>

### SENIOR COUNSEL

Elliott W. Gumaer, jr., Esq.  
Jon L. Schumacher, Esq.  
John D. Witmeyer, Esq.

### COUNSEL

Katherine L. Babson, Jr., Esq.  
William F. Broll, Esq.  
Cynthia A. Brown, Esq.  
John H. Clymer, Esq.  
Ronald Garmey, Esq.  
David F. Hayes, Esq.  
Nicole M. Marro, Esq.  
George J. McCormack, Esq.  
Lazaro J. Mur, Esq.  
William V. Tripp III, Esq.  
Howard J. Wiener, Esq.

### ASSOCIATES

Michael S. Canfield, Esq.  
Jennifer Collins, Esq.  
Courtney E. Harrison, Esq.  
Eric D. Karlberg, Esq.  
Karolyn R. Plummer, Esq.  
Christine A. Sackett, Esq.  
Patrick J. Simpson, Esq.  
Jason P. Torres, Esq.

### PARALEGALS

Karen S. Baumgartner

### E-MAIL NAME

danderson  
sconnolly  
cdixon  
tfarace  
jfitzgerald

jgarrett  
emoreno  
pmorrison  
snewman

jvotava

egumaer  
jschumacher  
jwitmeyer

kbabson

cbrown  
jclymer  
rgarmey  
dhayes  
nmarro  
gmcormack  
lmur  
wtripp  
hwiener

meanfield  
jcollins  
charrison  
ekarlberg  
kplummer  
csackett  
psimpson  
jtorres

kbaumgartner

### PHONE

617-345-1206  
617-345-6075  
585-263-1075  
585-263-1440  
585-263-1357 Rochester  
617-345-1081 Boston  
212-940-3034 New York  
516-832-7517 Long Island  
585-263-1271  
617-345-6157  
585-263-1657  
716-853-8127 Buffalo  
561-691-5424 Palm Beach  
585-263-1450 Rochester  
202-585-8355 Washington

585-263-1268  
585-263-1263  
585-263-1276

617-345-6008  
415-984-8347  
617-345-1332  
617-345-6072  
617-345-6113  
617-345-1224  
585-263-1623  
212-940-3090  
561-691-5427  
617-345-1376  
561-691-5425

585-263-1042  
617-345-6074  
617-345-6056  
617-345-1248  
415-412-7156  
585-263-1273  
585-263-1023  
585-263-1165

585-263-1622

### ALBANY, NY

677 Broadway, 10th Floor  
Albany, NY 12207  
518-427-2650

### BOSTON, MA

100 Summer Street  
Boston, MA 02110  
617-345-1000

### BUFFALO, NY

Key Towers  
40 Fountain Plaza,  
Ste. 500  
Buffalo, NY 14202  
716-853-8100

### CHICAGO, IL

161 N. Clark Street  
48<sup>th</sup> Floor  
Chicago, IL 60601-3213  
312-425-3900

### HARTFORD, CT

City Place  
185 Asylum Street  
Hartford, CT 06103  
860-75-6820

### LONDON, UK

Hillgate House  
26 Old Bailey, 11<sup>th</sup> Floor  
London EC4M 7HQ, UK  
+44 (0) 20 7653 9760

### LONG ISLAND, NY

50 Jericho Quadrangle  
Suite 300  
Jericho, NY 11753-2728  
516-832-7500

### LOS ANGELES, CA

Gas Company Tower  
555 W. Fifth St., 46th Fl.  
Los Angeles, CA 90013  
213-533-1050

### MANCHESTER, NH

900 Elm Street  
Manchester, NH 03101  
603-628-4000

### NEW YORK, NY

437 Madison Avenue  
New York, NY 10022  
212-940-3000

### PALM BEACH GARDENS, FL

7121 Fairway Drive  
Suite 203  
Palm Beach Gdns., FL 33418  
561-691-5420

Sarah A. Bunt	sbunt	617-345-1115
Vicky Cornish	vcornish	585-263-1204
Yvonne E. Franks	yfranks	617-345-6110
Eileen T. Hansberry	ehansberry	617-345-6120
Donna J. Jackson	djackson	585-263-1093
Deborah J. Wilcox Mabry	dmabry	585-263-1350
Mary-Benham B. Nygren	mnygren	617-345-6165
Kimberly A. Rabideau	krabideau	585-263-1697
Susan T. Ruef-Statt	sruef-statt	585-263-1103
Geri A. Zamber	gzamber	716-848-8204

**PROFESSIONAL SPECIALISTS**

Kelly Acevedo	kacevedo	585-263-1057
Joseph F. Banach	jbanach	585-263-1253
Noreen Bayfield-Austin	naustin	617-345-6033
Amy Bidleman	abidleman	585-263-1256
Christopher F. Caldwell, EA	ccaldwell	617-345-6058
John T. Cole	jeole	617-345-6073
John E. Corbett	jeorbett	617-345-6034
Anne Covert	acovert	585-263-1401
Linda M. Dispensa	ldispensa	617-345-6119
Elaine M. Dixon	edixon	585-263-1588
Lawrence F. Dooley, Jr., CFA	ldooley	617-345-6095
Mary-Ellen Dota	mdota	617-345-6096
Ritchie F. Emmons	remmons	617-345-6104
Linda R. Feldman	lfeldman	617-345-6108
Brian J. Gibbons	bgibbons	617-345-6185
Stephen G. Green, CFP®	sgreen	585-263-1669
Lisa Hickey	lhickey	617-345-6083
Darrell Kamholz, CPA	dkamholz	585-263-1272
Dennis W. Kushmerek	dkushmerek	617-345-6136
Yelena Kuznetsova, CPA	ykuznetsova	585-263-1351
Scott Lefebvre, CPA	slefebvre	585-263-1647
Dimitrios Manou, CPA	dmanou	585-263-1288
Genie McKeown, CPA, CFP®	gmckeown	585-263-1266
Kevin T. McQuaid, EA, CFP®	kmcquaid	617-345-6151
Grant G. McQuillan	gmcquillan	617-345-6152
Sharon Memmolo	smemmolo	617-345-6155
Monica Murray	mmurray	585-263-1404
Jason Nicholson, CPA	jnicholson	585-263-1563
E. Thomas O'Hara, Jr., CFA	tohara	617-345-6166
Masha Rabkin, CPA	mrabkin	585-263-1117
Gail Robinson	grobinsin	617-345-6022
James T. Robinson	jrobinson	617-345-6178
Michael J. Ruschioni	mruschioni	617-345-1328
Paul Russo	prusso	617-345-6129
Gail L. Simonds	gsimonds	617-345-6190
Frederick F. Soares, EA	fsoares	617-345-6191
Alyson L. Stevenson, CPA	astevenson	585-263-1262
Christine Tshudy, CFA	ctshudy	617-345-1078

**DIRECTOR OF FIDUCIARY AND CONSULTING SERVICES:**

Charles S. Gaziano	cgaziano	617-345-6115
--------------------	----------	--------------

**PARIS, FRANCE**  
32 rue de Monceau  
75008 Paris, France  
+33(0) 1 53 53 68 94

**PHILADELPHIA, PA**  
Two Penn Center, Suite 200  
1500 JFK Boulevard  
Philadelphia, PA 19102  
215-854-4096

**PROVIDENCE, RI**  
One Citizens Plaza  
Providence, RI 02903  
401-454-1000

**ROCHESTER, NY**  
1100 Clinton Square  
Rochester, NY 14604  
585-263-1000

**SAN FRANCISCO, CA**  
One Embarcadero Center  
18<sup>th</sup> Floor  
San Francisco, CA 94111  
415-984-8200

**SHANGHAI, PEOPLE'S  
REPUBLIC OF CHINA**  
Bund Center  
18th Floor (Office 1863)  
222 Yan An East Road,  
Shanghai 200002  
People's Republic of China

**SILICON VALLEY, CA**  
200 Page Mill Road  
2nd Floor  
Palo Alto, CA 94306-2022  
Phone: 650-320-7700

**WASHINGTON, D.C.**  
Suite 900  
401 9th Street NW  
Washington, DC 20004  
202-585-8000