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2012 Estate Planning Year in Review

"Hey Toreador . . . she signals, we head for the edge and the first man who jumps is a chicken."
- Buzz to Jim (James Dean) in *Rebel Without a Cause* (1955)

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TALES OF OUR TIMES

The Big Screen Version

The dreaded "fiscal cliff" raised the specter of Hollywood's best depiction of a car as it heads over a precipice and drops in spectacular free-fall until it explodes in a fireball on the massive rocks in the ocean surf. The script is straight out of *Rebel Without a Cause*, the famous 1955 movie starring James Dean and Natalie Wood. Picture the scene as cast today. Two cars pointed toward the cliff. Behind the wheel of one car is Senate Majority Leader Harry Reid. Behind the wheel of the other is House Speaker John Boehner. Both are revving their engines, waiting for Natalie Wood (in this scene, the role is filled by Nancy Pelosi . . . or is it Michele Bachmann?) to give them the starting signal while the crowd of onlookers cheers them on. Boehner yells out his window to Reid, "Hey Toreador . . . she signals, we head for the edge, and the first man who jumps is a chicken." We know the outcome - - what began as a rebellious teen challenge ends in death. Awww, who would have guessed it wouldn't end well?? The scene is a classic: http://www.youtube.com/watch?v=u7hZ9jKrwvo

The House Speaker's Dream Version

Alice: *"How puzzling all these changes are! I'm never sure what I'm going to be, from one minute to another."*

- Lewis Carroll, *Alice's Adventures in Wonderland*

Once upon a time, long ago, in a faraway land, there lived a people who had a complex system of trading goods and services. The universal bartering medium for all goods and services was called money. People who managed to amass vast sums of money were able to acquire luxuries that could scarcely be imagined by those who struggled to provide food, clothing and shelter for themselves and their families. The governing council over this faraway land imposed a tax on people's money. There was a tax imposed on money as it was earned, another tax was imposed on money as it was spent, and yet another tax was imposed on money that hadn't yet been spent when a person died and left their surplus money to their children. The rules governing the imposition of taxes at first were simple and everyone understood them. However, over the course of time the rules became more and more complicated, until finally, the book containing the tax laws became so ponderous and the print so small, no one could read the laws without a strong magnifying glass and even then, few people understood them. People tried to plan their affairs to earn, spend and give their surplus money to their children in the most tax efficient way possible, but every time they made a plan, the governing council changed the rules. Sometimes they changed the rules for one year at a time, sometimes for two years at a time. Sometimes they changed the rules retroactively. They changed them so often no one knew anymore what the rules would be even weeks into the future . . . all they knew with certainty was that the rules would change. A new profession came into being to deal with the ever changing rules:

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tax law guesstimators. Tax law guesstimators became a revered class of fortune-tellers who practiced their trade by the use of mystical potions, crystals, and secrets unknown to anyone but themselves. Some spoke in tongues. Others fasted for weeks on end to enable them to divine the future of the tax laws. The guesstimators who were most revered for the accuracy of their predictions were believed to have found enlightenment by disemboweling stray dogs in a graveyard under a full moon.

The House Speaker was jolted out of his sleep by the alarm. He always had such bizarre dreams when he took NyQuil. Fortunately, his head cold seemed slightly better today.

How Did this Happen?

What become popularly known in recent years as the Bush tax cuts was originally known as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Within months of President George W. Bush taking office in 2001, with the country awash in budget ***surplus***, Congress passed EGTRRA as a $1.35 trillion tax reduction package that changed income, gift, estate and generation skipping transfer taxes.

The tax law changes of EGTRRA were phased in over several years and the law included a "sunset provision" that, as of January 1, 2011, would return the tax laws to the status that existed before EGTRRA was passed. Among the Bush tax cuts was a staggered increase in the federal estate tax exemption amount (the amount that each person can leave on death to his or her non-spouse heirs, free of estate tax). In 2001 that amount was $675,000. EGTRRA increased the exemption amount as follows:

2002 – 2003	- $1 million
2004 – 2005	- $1.5 million
2006 – 2008	- $2 million
2009	- $3.5 million
2010	- Unlimited (estate tax "repeal")
2011+	- $1 million

As the estate tax exemption amount grew from $1 million to $2 million, and then to $3.5 million, everyone was confident that Congress would revisit the Bush tax cuts before 2010 to head off the scheduled repeal of the estate tax. Compounding the political, economic and philosophical issues inherent in a repeal of the estate tax, with the country facing unsustainable increases in the annual budget deficit, it seemed improbable that Congress would, by its own inaction, let the estate tax be repealed even for one year. After all, the primary impetus for the Bush tax cuts was the budget surplus that we enjoyed for three consecutive years and was projected to continue into the future. But, as 2010 approached, the budget surpluses of 1998, 1999 and 2000 were a fading memory.

Yet, as the clock ticked down on the final weeks of 2009, Congress was focused on a national health care program and the improbable happened. On January 1, 2010 the estate tax was repealed because Congress did nothing to stop it. As a result, a number of ultra-wealthy families enjoyed a financial windfall from the death of a family matriarch or patriarch during the one-year repeal.

Alice: *"Better read it first, for if one drinks much from a bottle marked 'Poison', it's almost certain to disagree with one sooner or later."*

- Lewis Carroll, *Alice's Adventures in Wonderland*

A year later, as the repeal was nearing its end and the expiration of the Bush tax cuts loomed over December 31, 2010, threatening to return the federal estate tax exemption to $1 million, the country was still in recession and the specter of raising taxes was considered a recipe for derailing

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any hope of an economic recovery. Two weeks before the Bush tax cuts were scheduled to expire, Congress extended the cuts for two more years ("kicking the can down the road") until December 31, 2012, taking the first giant step toward the fiscal cliff. As part of the two year extension of the Bush tax cuts, rather than go from the extreme of estate tax repeal to the extreme of a $1 million estate tax exemption, Congress set the estate tax exemption at $5 million – but only for two years.

The second giant step toward the cliff was taken in August of 2011 when Congress voted to increase the national debt ceiling by $2.7 trillion dollars, required an offsetting $2.7 trillion in deficit reduction by the year 2021, and formed a bipartisan "super-committee" to figure out how to achieve $1.2 trillion of deficit reduction. When the super-committee failed to reach an agreement on how to achieve the required deficit reduction, the failure triggered automatic across-the-board cuts split evenly between defense and domestic spending (the "sequestrations"), beginning on January 2, 2013. The confluence of the expiration of the Bush tax cuts as of January 1 and the imposition of the spending cuts as of January 2 created the fiscal cliff.

As of December 31, 2012, neither House Speaker Boehner nor Senate Majority Leader Reid was willing to jump out of the car. Both appeared to prefer to go over the cliff rather than suffer the label of being called a chicken. Miraculously, while hurtling toward the rocks below, both ejected and pulled their ripcords, landing safely on the American Taxpayer Relief Act of 2012. Here are the estate planning highlights:

Estate Tax Exemption

The federal estate tax exemption continues at the 2012 level, adjusted for inflation. The exemption is expected to be $5,250,000. The top estate tax rate increases from 35% to 40%. This is a "permanent" fix that gives us planning stability for the first time in many years. The exemption amount will continue to be adjusted annually for inflation.

Portability

Until 2011, if a married couple had an estate that was large enough to be subject to federal estate tax and the couple wanted to minimize the estate tax burden on their heirs, estate tax savings provisions needed to be in the estate planning documents of the first spouse to die. Unless the federal estate tax exemption of the first spouse to die was used by the time of his or her death, it was lost. Even though the surviving spouse inherited all the assets of the first spouse to die, the surviving spouse didn't inherit the deceased spouse's federal estate tax exemption. The exemption was not transferrable to the surviving spouse.

Beginning in 2011, the estate tax exemption became "portable" . . . transferable to the surviving spouse. The 2011 law implemented portability for only two years and was scheduled to expire with the Bush tax cuts on December 31, 2012. The new law extends portability permanently. See our *2010 Estate Planning Year in Review* on our website for a detailed explanation of portability, but the essence is this: assume that as of January 1, 2013 husband and wife each has a federal estate tax exemption of $5,250,000 and that they own $10 million of assets between them. Husband dies, leaving all of his assets to his wife using a "simple" will. Without portability, husband's estate tax exemption would be lost at his death and wife would end up the owner of the entire $10 million estate and with only $5,250,000 of exemption to shelter assets from estate tax at her death, leaving $4,750,000 of assets subject to federal estate tax. With portability, wife receives

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husband's $5,250,000 of unused exemption and can now leave the entire $10 million estate to their children at her death completely sheltered from federal estate tax with the use of her $10,500,000 of exemption, half of which she received from her husband.

As discussed in our *2010 Estate Planning Year in Review* there are still many non-tax related reasons to create a trust for the surviving spouse despite the fact that portability is now a permanent part of the estate tax laws. For example:

- A trust can ensure that the assets are used for the benefit of the surviving spouse and are then distributed as desired by the first spouse to die and not to a new spouse if the surviving spouse remarries, or to the surviving spouse's children from a prior marriage.
- A trust can provide creditor and divorce protection for the surviving spouse.
- A trust can provide assurance that the funds are professionally managed and invested for the benefit of a surviving spouse who may be incapable, as a result of inexperience or disability, of properly managing the funds.

And, in Maine, with a state estate tax exemption substantially smaller than the federal estate tax exemption, a trust for the surviving spouse will often be appropriate to minimize or eliminate Maine estate tax at the death of the surviving spouse.

GIFT TAX

The new law retains a "unified" federal gift and estate tax exemption. Therefore the gift tax exemption is expected to be $5,250,000 in 2013 and will be adjusted for inflation in future years to match the estate tax exemption.

As of 2003, both the gift and estate tax exemption amounts were $1 million. Each person had $1 million of exemption that could be used to transfer wealth to a non-spouse beneficiary free of federal gift and estate tax. The federal estate tax exemption increased to $1.5 million in 2004, to $2 million in 2006, and to $3.5 million in 2009, but the gift tax exemption remained at $1 million. The result was that a person could only gift $1 million during lifetime without paying gift tax despite the fact that a larger amount could be transferred free of estate tax at death.

When Congress extended the Bush tax cuts for two years at the end of 2010, the extension included a couple of surprises, one of which was an increase in both the gift and estate tax exemptions to $5 million, creating "unified" exemptions for the first time since 2003. The reunification was a two year proposition, expiring as of the end of 2012.

Because no one knew whether Congress would let the Bush tax cuts expire at the end of 2012 and permit the federal gift and estate tax exemptions to return to the pre-EGTRRA levels of $1 million, some people with sufficient assets to do so took advantage of a perceived window of opportunity and used their entire $5,120,000 gift tax exemption during 2012 by making large gifts to their heirs or to trusts for their heirs. The surprise in the new law is that the window of opportunity didn't close. The window remains open, and thanks to the annual inflation adjustments, is open wider than ever. Gifting opportunities continue to be available for people who are inclined to make large lifetime gifts.

Although not part of the American Taxpayer Relief Act of 2012, the annual federal gift tax exclusion increased on January 1 to $14,000 (from $13,000 in 2012) and permits a person to give $14,000 a year to as many recipients

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as desired, without eroding the current $5,250,000 federal gift and estate tax exemption. Payment of tuition and certain medical expenses are not subject to gift tax and may be made in addition to the annual gift tax exclusion of $14,000.

Unlimited lifetime transfers between U.S. citizen spouses remain gift tax free. In 2013, the first $143,000 (increased from $139,000 in 2012) of an annual gift to a non-citizen spouse is gift tax free.

Generation-Skipping Transfer Tax

One of the more esoteric taxes, but a key part of estate planning, is the generation-skipping transfer (GST) tax. The mere thought of the GST tax can give estate planners a headache. Suffice it to say that for those who have integrated GST tax planning into their estate plans, the new law includes welcome news. The GST tax exemption remains unified with the federal estate and gift tax exemption amounts and will be adjusted each year for inflation.

Unlike the federal estate tax exemption, however, the GST tax exemption is not portable. If the first spouse to die does not effectively use his/her GST tax exemption as part of his/her estate planning, the GST tax exemption is lost. Therefore, for married couples interested in maximizing their ability to have assets benefit multiple generations of beneficiaries without having the assets be subject to estate tax at the death of each generation, the GST tax planning provisions need to be incorporated into the estate planning documents before the first death.

The Maine Estate Tax

"If the rich could hire other people to die for them, the poor could make a wonderful living."

- Yiddish proverb

As of January 1, 2013, Maine's estate tax exemption amount doubled from $1 million to $2 million.

With proper trust planning and titling of assets between married couples and unmarried domestic partners, the increase of the Maine exemption amount to $2 million will permit couples to leave $4 million to their heirs free of Maine estate tax at the time of the second death.

The disparity between the $2 million Maine estate tax exemption and the $5,250,000 federal estate tax exemption means that many estates will be subject to a Maine estate tax even though there is no federal estate tax liability. As a result, it is important that married couples and unmarried domestic partners who have estates of more than the amount of the Maine exemption ensure that their estate planning documents are designed to minimize Maine estate tax. In most cases, that will be accomplished by creating a trust for the benefit of the surviving spouse/ partner.

As of January 1, 2013, Maine also implements a new rate structure for determining the amount of estate tax due. Until now, the calculation of Maine estate tax was based on thirteen different tax rates depending on the size of the estate, with tax rates ranging from 6.4% to 16%. The new tax structure has just three tax rates ranging from 8% to 12%. The rate structure will

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reduce the estate tax burden for all estates that are subject to tax. The new tax rates are:

- Up to $2 million: no tax
- Greater than $2 million and no more than $5 million: 8% of the excess over $2 million
- Greater than $5 million and no more than $8 million: 10% of the excess over $5 million
- Above $8 million: 12% of the excess over $8 million

Maine has no gift tax, but gifts made within one year of death are included in the calculation of the Maine estate tax.

An Exciting Development for Same-Sex Partners

"Had Marilyn Monroe's film been called 'How to Register a Domestic Partnership with a Millionaire,' it would not have conveyed the same meaning."

- Ninth Circuit Court of Appeals in *Perry v. Hollingsworth*, invalidating California's Proposition 8, which restricted the definition of marriage to opposite-sex couples.

These are landmark times for same-sex partners living in Maine. Although Maine has long awarded certain rights to same-sex partners who chose to "register" with the state, the November vote on Question 1 made Maine among the first states in the country to legalize same-sex marriage by popular referendum vote. The first couples to take advantage of the new law were married on December 29. The state rights that flow from the recognition of same-sex marriages will include all rights that are enjoyed by traditional opposite-sex marriage partners in Maine, including the unlimited marital deduction for assets transferred to a surviving spouse at death.

With Maine having recognized same-sex spouses, the next battleground for the rights of same-sex spouses is federal law. In 1996, Congress passed, and President Clinton signed into law, the Defense of Marriage Act ("DOMA"). DOMA defines marriage for purposes of all federal law as the "legal union between one man and one woman as husband and wife." It defines "spouse" as "a person of the opposite sex who is a husband or wife."

In 2010 the constitutionality of DOMA was challenged by Edie Windsor, a resident of New York whose same-sex spouse died in 2009. Edie and her spouse were legally married in Canada in 2007. When Edie's spouse died and left her estate to Edie, DOMA prevented Edie from claiming a marital deduction and as a result, the estate paid $363,000 of federal estate tax. Edie filed suit in the United States District Court, claiming that DOMA was a violation of the Equal Protection Clause of the United States Constitution. Three months after the suit was filed, the United States Department of Justice, which is charged with defending the constitutionality of federal laws, announced that it would not defend DOMA's constitutionality. The District Court ruled that DOMA was unconstitutional. The Second Circuit Court of Appeals affirmed the District Court, and the Supreme Court recently agreed to hear the case. The case is expected to be argued in March 2013. If the Supreme Court declares DOMA unconstitutional, we'll be able to use estate planning techniques for our married same-sex partner clients that have historically been denied them.

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State of the Estate Review

Our *State of the Estate Review* is an acknowledgement that estate planning is a process, not an event. It is reasonable to expect that the decisions we make in one year will, in light of additional life experience, be subject to change to match our evolution of thought, changes in the law, changes in finances and changes in the life status of our beneficiaries.

The frequency with which you update your estate plan is left to your discretion. However, if it has been more than a few years since you updated your plan, we encourage you to call to schedule a *State of the Estate Review* of your existing estate planning documents and to discuss updates that may be appropriate for both tax and non-tax reasons. Absent your request to schedule a *State of the Estate Review*, we will not be responsible for reviewing or updating your estate plan to reflect changes in the law or for other purposes.

Equally important as a review of your estate planning documents is a review of beneficiary designations and the way accounts are titled. Joint accounts, pay-on-death and transfer-on-death designations, and beneficiary designations for retirement accounts, annuities and life insurance policies are each mini-estate plans and should be carefully coordinated with your will or revocable trust.

Everyone has concerns that occasionally keep them awake at night . . . concerns for themselves and their families. To the extent we can, we do our best to help address those concerns as part of the planning process. Minimizing transfer taxes and maximizing the amount that can pass to the next generation is only part of the conversation. When, at the end of the planning process, clients say, "Thank you. It feels great to have this in place. I'll sleep better at night," they're never referring to the fact that they've saved estate taxes for their heirs. Although no one wants to needlessly pay taxes of any kind, our experience is that people don't lose sleep over the estate tax. Thoughtful estate planning addresses far more than estate taxes.

A Great Place to Practice Law

In 2012, 43 lawyers at Drummond Woodsum were each recognized by their professional peers in *Super Lawyers* and/ or *Best Lawyers* for their work in the fields of trust and estate planning, tax law, commercial litigation, Native American law, education law, labor and employment law, banking law, corporate law, intellectual property law, mergers and acquisitions law, bankruptcy and creditor-debtor rights law, land use and zoning law, municipal law, real estate law, public finance law and alternative dispute resolution. In addition, five of our lawyers were recognized in *Best Lawyers* as *Rising Stars* in various fields of practice. *Rising Stars* are selected by our peers as the best attorneys who are no more than 40 years old, or who have been practicing for 10 years or less. It's an honor for all of us to work in an environment with so many exceptional lawyers. Jessica Scherb (formerly Emmons) was named a *Rising Star* in estate planning and probate, and in mergers & acquisitions. She's a superbly talented lawyer in both practice areas. David Backer and John Kaminski were recognized by *Super Lawyers* for their work in estate planning and probate. In addition, David was recognized by *Best Lawyers* for his work in trust and estate planning and John was recognized by

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Super Lawyers for his work in tax and real estate and by *Best Lawyers* for his work in tax law. David and John are both elected Fellows of the American College of Trust and Estate Counsel. A lawyer cannot apply for membership in the College; Fellows of the College are selected on the basis of professional reputation and ability in the fields of trusts and estates.

Other members of the trust and estate planning group were recognized as well. Chris Stevenson, who practiced as a certified public accountant before heading to law school, adds tremendous depth to our ability to advise our clients on tax issues impacting their estate planning. Chris was named a *Rising Star* in tax law as well as in employee benefits/ERISA.

And, when disputes erupt during the administration of an estate or trust, we routinely turn to Dave Sherman, who chairs our Trial Services Group. Dave has broad experience in resolving estate, trust and other disputes in the Maine Probate Courts. Dave was recognized by *Best Lawyers* for his litigation skills as well as his work in bankruptcy and creditor-debtor rights/ insolvency and reorganization.

In 2012 David Backer continued his role as Chair of Maine's Probate and Trust Law Advisory Commission, which was created by the Maine legislature in 2009. The Maine legislature's Judiciary Committee regularly turns to the Commission for recommendations on changes to Maine's probate and trust laws.

Thank You for Your Trust

We take seriously the trust that you place in us and will continue to do everything possible to continue to earn that trust.

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To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication was 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 tax related matter.

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