NEW ESTATE TAX LAW:
WHITHER GOEST THE TRUST?

Background

Prior to the enactment of the changes to the federal estate tax laws made late in 2010, classic estate tax planning, even for couples of relatively modest wealth, was the so-called "A/B Trust" model. Under this approach, the amount that could be passed tax free on the death of the predeceasing spouse ("exempt amount" which ranged from $1,000,000 to $3,500,000, depending on the year of death) was allocated to a trust ("exempt trust") which provided for discretionary distributions of income and principal to the surviving spouse and children. Any amount in excess of the exempt amount was allocated to another trust ("marital trust") which provided for mandatory distributions of income to the surviving spouse and was not taxed in the predeceasing spouse's estate. The assets in the exempt trust were not included in the taxable estate on the death of the surviving spouse but the marital trust was part of the surviving spouse's taxable estate. In this manner, the maximum amount could be passed estate tax free to the children and any estate tax was deferred until the death of the surviving spouse.

New Estate Tax Law

Under the new estate tax law, the use of the two trust approach may no longer be necessary to maximize estate tax efficiency. This is due to a new "portability" option where any unused exempt amount of the predeceasing spouse can be "transferred" to the surviving spouse. Under this approach, in theory, the entire estate of the predeceasing spouse could be bequeathed outright to the surviving spouse and not be taxed in the predeceasing spouse's estate. Then, if the executor of the predeceasing spouse so elected, the entire unused exempt amount of the predeceasing spouse (which would be $5,000,000 in 2011 and 2012) would be available to reduce the estate tax of the surviving spouse. This could mean that as much as $10,000,000 could be passed estate tax free on the death of the surviving spouse.

Reliance on portability for planning may be warranted in certain cases, but there will remain many instances where the use of trusts is still necessary and advisable in estate planning. First, the new portability law is set to expire after 2012. Most experts predict that portability will remain in the law in some fashion after 2012, but current planning should take into account the possibility of its expiration. Second, if the surviving spouse were to remarry, there could be a loss of the predeceasing spouse's unused exempt amount if the new spouse also were to predecease the surviving spouse, since only the unused exempt amount of the most recently predeceased spouse is available. Also, depending on appreciation in the value of the assets and the rate structure at the time of the survivor's death a pure portable approach could result in more estate tax on the combined estates. Finally, there are vastly differing income tax consequences to be considered due to the basis adjustments to assets owned at death.

Continued Uses of Trusts in Estate Planning

Trusts continue to provide benefits outside of estate tax, may in fact be necessary under Louisiana law and certainly are more predictable at least until the estate tax law is made permanent.

Forced Heirship

Contrary to popular conception, forced heirship still exists under Louisiana law. While it generally is limited to children age 23 and under, it can also apply in the case of disabled children. The definition of disability is broad enough that there is a very real possibility of a child becoming a forced heir after a will is drafted so there is risk in having a will that fails to take into account this possibility. Since an outright bequest to the surviving spouse does not satisfy forced heirship, in the event that a child was to become a forced heir (for example, through disability) and a will could not be re-drafted to take that into account, the share of the forced heir, even if burdened with a legal usufruct, would not qualify for the estate tax marital deduction, which increases the potential of estate tax on the death of the predeceasing spouse.

Generally, forced heirship fits within estate tax planning through a usufruct for life or a properly drafted trust instrument. The usufruct approach is riskier due to recent changes to the law of usufruct that have clarified the rights of naked owners and usufructs may not be appropriate in the context of all children. The better solution appears to be a testamentary trust with fail-safes for the possibility of forced heirs.

Post-Death Issues

If the predeceasing spouse leaves everything to the surviving spouse, there is no assurance that his or her assets will end up where he or she intended, as the surviving spouse has the absolute right to modify his or her testament regarding the disposition of these assets. Further, trusts can provide for appropriate administration of the assets of children who are too young or incapacitated at the death of the surviving spouse

Asset Protection

In today's litigious environment, protection of assets is an essential component of estate planning. Assets held outright by the surviving spouse would generally be subject to all claims, while assets held in trust containing appropriate provisions are not generally subject to the claims of creditors of the trust's beneficiaries.

Trusts for Lifetime Planning

There also remain many uses of trusts for lifetime tax and estate planning. For example, there are benefits in appropriate circumstances to placing significant assets in lifetime revocable trusts which contain provisions regarding disposition of the trust assets following the death of the trust's settlor. Typically, the settlor also would have a will leaving any remaining assets to the trust. This approach provides for simplified estate administration, privacy as to ownership of assets and ease of management on disability of the settlor.

There also are a number of advanced estate planning techniques (such as irrevocable insurance trusts, intentionally defective grantor trusts, qualified personal residence trusts and grantor retained annuity trusts) all of which require the use of lifetime trusts. Depending on the outcome of estate tax reform, these techniques may not be available following 2012. The current $5,000,000 gift and generation skipping tax exemption makes the use of these techniques even more attractive and effective in appropriate circumstances.

Conclusion

Trusts continue to be essential components of the estate plan. Anyone desiring to use lifetime trusts in their advanced planning should considering implementing the plans in the next 18 months or it may be too late.

For further information, please feel free to contact J. Grant Coleman.