LeBlanc & Young

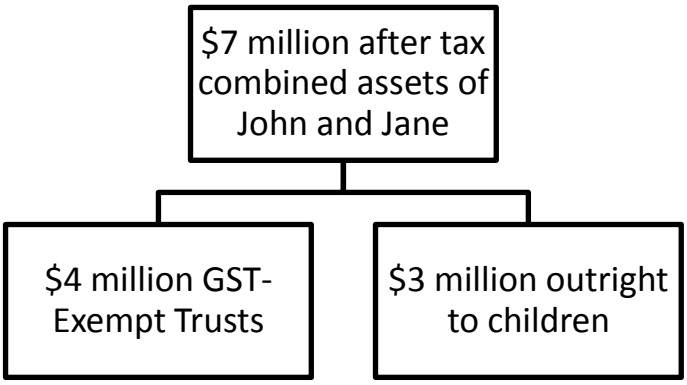
Newsletter December 2008

Happy New Year – Your Exemptions are Increasing!

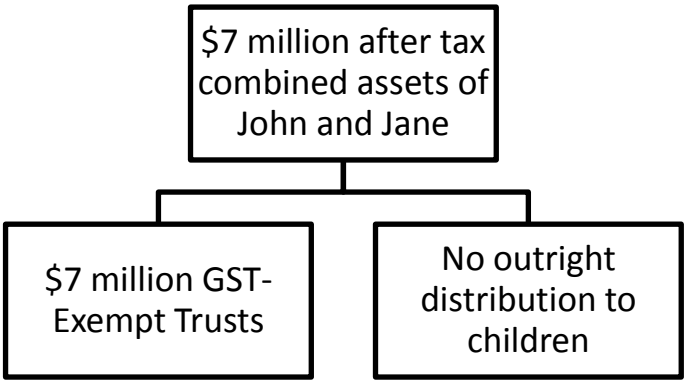
That is not something that we anticipate will be on the tip of the tongues of many revelers on January 1, 2009, but it could well be! The federal estate and generation-skipping tax exemptions, which are currently $2 million for each individual, are scheduled to increase to $3.5 million per person as of January 1, 2009 under our current federal tax law. This may require a review or analysis of estate plans that utilize typical credit shelter or exemption estate tax planning. Such plans include the fairly typical LeBlanc & Young pourover will and revocable trust combination, or a more simplified will that contains a credit shelter trust. Estate plans that rely purely on disclaimer planning are not impacted by this change.

How can you tell if the increase in exemptions will have an impact on your plan, and what that impact might be? If your estate plan creates a family trust, a credit shelter trust, a generation-skipping or "GST Exempt Trust," or Maine Marital Trust, it is likely based on formulas derived from the federal tax exemptions and, thus, allocations among the various types of trusts in the documents will be changed by the increase in these exemptions. We can help you determine if your plan is one that is affected by this pending change. What does this mean in simple terms for your estate plan? It may increase the portion of your estate held in trust and decrease the portion passing outright to your spouse or children. For example, if John and Jane had done estate planning based on the assumption that no more than $2 million would be held in trust for the benefit of the family on the death of the first to die, and the balance of the deceased spouse's assets would pass outright to the surviving spouse, the increase in the exemptions will change the distribution of assets. If John dies first, instead of having $2 million held in trust, up to $3.5 million of his assets would be held in trust and it is possible that Jane would receive nothing at that time free of trust. This may not be what John and Jane want. Similarly, if John and Jane had used maximum generation-skipping planning, thinking that $2 million of their assets at each death would ultimately be held in trust for the benefit of children for life and then grandchildren, and the excess assets would pass free of trust to the children (an aggregate trust benefit of $4 million for them), because of the increase in exemptions, the amount to be held in generation-skipping trusts from each of John and Jane increases to $3.5 million (a total of $7 million) and the amount that the children receive free of trust will be diminished or perhaps eliminated. Such results may be fine if that is what you would like in your plan for your family, but it may hold more assets in trust than you intend and more than is needed to accomplish your required tax planning. In short, the trust planning may be excessive for the size of your aggregate estate, and a simpler plan might be a better choice for you and your family.

Distribution under $2 million exemption



Distribution under $3.5 million exemption



There are various ways to address the impact of these changes on estate plans, perhaps capping the amount held in trust by limiting it to a lower amount. We can discuss how you might want to address this in your situation. In order for us to analyze the impact of the increase in exemptions on your plan to determine if a change is appropriate, it will be helpful to have an updated asset balance sheet, reflecting ownership divisions between

spouses if appropriate. Please call the office if you would like a form to use in updating your asset information.

What happens if you do nothing and do not have your plan reviewed at this time? There will likely be no significant estate tax downside – indeed, individuals whose estates may have been exposed previously to federal estate tax may no longer have a federal estate tax due upon their death. It is possible that an older formula, when combined with the value of your assets and the increase in the exemptions, may create an income tax concern that will need to be monitored at the time your assets are divided into the various trusts during estate administration, although often that exposure can be limited by careful administration. The most significant risk is that your survivors may have more held in trust for them and less distributed to them free of trust than either you or they anticipated.

Although no one at this point can predict with any certainty what might happen to the estate tax laws in 2009 and beyond, most who keep a watchful eye on this believe that the oddities scheduled to occur (an initial repeal of the tax in 2010 followed in 2011 by a reinstatement with an exemption of $1 million) will not happen, and that in 2009, Congress will be forced to "fix" the estate tax. Press reports (including technical tax pundits) have indicated that President-elect Obama favors freezing the estate and generation-skipping tax at the 2009 point, with a $3.5 million exemption and a flat rate of 45% for estates that are taxable. That seems a very possible outcome, although we are simply reading "tea leaves" and the press, just like you. We will endeavor to keep you informed of any pertinent legislative changes as they may evolve. ■

Gotcha! – Maine Estate Tax Surprises

A byproduct of the sweeping changes to the federal estate tax system in 2001 was a shift of estate tax receipts from the states to the federal government. Since the 2001 changes, states have grappled with how best to respond. Some states, like Florida, did nothing and, as a result, now have no state estate tax. Other states, like Maine, have amended their estate tax statutes to establish independent estate tax systems. In effect, the pre-2001 estate tax system, which was fairly unified across state lines, has been replaced by a disjointed system resulting from this state-by-state response.

One of the consequences of this fractured system is incentives for people to change their state of domicile to minimize their state estate tax liability. However, changing domicile may not eliminate one's state estate tax liability altogether. In fact, individuals who own property in multiple states must take great care to insure that their estate plan is crafted in a manner that takes advantage of the laws of each state in which the individual owns real estate or tangible property. Without careful planning, estates of decedents who owned property in different states could pay additional state estate taxes that could have been avoided. Additionally, there may be a risk that an estate may be taxed by more than one state for the same property.

Recently, we have heard from estate planning attorneys in other jurisdictions who are surprised to learn (often after the death of a client) that a person domiciled in another state who owns real property in Maine is liable for a Maine estate tax. For example, a Florida husband with an estate valued at $2.5 million who owns a summer home in Maine and has a typical two-part federal estate plan (Credit Shelter Trust and Marital Distribution) will pay no federal estate tax (because of the marital deduction) and no Florida estate tax (because there is no longer a Florida estate tax), **but his estate will be liable for a Maine estate tax**. This results even if the Florida husband specifically left his Maine property to his wife (and took advantage of the unlimited marital deduction) or specifically left the Maine property to a charity (and took advantage of the unlimited charitable deduction). In fact, this results even if Husband and Wife own the Maine property jointly and the property passes automatically to Wife as the surviving joint tenant. The only way to eliminate the Maine estate tax on the first death is to have an estate plan that takes advantage of the separate Maine marital deduction through a Maine QTIP election. Although this is a concept which Maine estate planners have been using for several years, it may not be understood by estate planners in other states. The flip-side of this issue is the impact on Maine residents who own property in other states. If you are a Maine resident and own real estate in another state, you should engage an estate planning attorney in that state to review your Maine documents to insure that there are no surprises in the second state upon your death. If you fall into this category, we would be happy to work with you to locate an appropriate out-of-state attorney and assist in any such review.

Another troubling consequence of this state-by-state system is the potential for double taxation by various states. Again, this is an issue for people who own property in multiple states. By way of background: historically, an

individual could transfer real property (taxable by the state where the property is located) into a trust or limited liability company or other pass-through entity and thereby convert that asset to intangible personal property (an interest in the pass-through entity) which is taxable by the state in which the decedent is domiciled. Returning to the Florida couple above, some thought that under prior law Husband and Wife could transfer their Maine house to a limited liability company and thereby avoid having to pay a Maine estate tax upon Husband's death because Husband was not domiciled in Maine and did not own any Maine real estate (he owned an interest in a limited liability company that owned Maine real estate).

In an effort to prevent out-of-state residents from using this technique to avoid the Maine estate tax, the Maine Legislature amended the statute governing the taxation of nonresident estates to provide that Maine will ignore so-called pass-through entities that hold Maine real estate and tax those nonresident estates as if the decedent had owned the Maine property outright and not in a pass-through entity such as a trust or limited liability company. Now, when the Florida resident Husband dies owning interests in a limited liability company that owns the family's summer home in Maine, our State will tax the estate as if Husband owned the Maine real estate outright.

This may be a fair result for our Florida Husband because he is no worse off than if he had owned the Maine real estate outright, because there is no Florida estate tax. However, if Husband lived in a state that has an estate tax (say, Massachusetts), his estate could be subject to double taxation on the Maine property. If Husband were domiciled in Massachusetts, his interest in the Maine limited liability company could be taxable by Massachusetts as an intangible asset. However, that asset could also be taxable by Maine as real property because the State ignores the pass-through entity, thereby causing a potential double tax on the Maine property. Again, many out-of-state estate planners may not be aware of this Maine-specific "wrinkle" in the law, and if you own real estate (either outright or in some other form) in more than one state, you would be well advised to engage local counsel to insure that there are no tax surprises upon your death.

We are no longer in a simple one-size-fits-all estate taxation system. Each state has dealt with the 2001 federal changes in its own way. There are many quirks in the Maine system, which are counterintuitive and which have surprised out-of-state attorneys and nonresidents who own Maine property. There are surely other state-specific quirks in other jurisdictions. If you own property in multiple states, your estate plan should be reviewed by attorneys in each state in which you own property in order to take into account each state's tax system and in order to insure that there are no tax surprises upon your death. We would be happy to assist you in locating an out-of-state attorney and working with that attorney to review your plan in an efficient manner. ■

You May Still Be a Maine Resident and Not Know It

If you are a Maine resident and decide you want to change your domicile (primary residence) to another state, it may come as a surprise to you that the term "domicile" is not a clearly defined term in Maine's tax statutes. The closest thing to a definition can be found in a 2006 decision by the Maine Supreme Judicial Court, which noted that the "somewhat elusive concept" of domicile involves two key components: (1) having a primary residence, and (2) intending to maintain it as your primary residence. Maine Revenue Services makes the same basic point on its income tax website, noting that your domicile "is the place you intend to make your home for a permanent or indefinite period of time. It is generally the place where you dwell and which is the center of your domestic, social and civic life." In other words, it is your "home base." A person can have multiple residences, but only one domicile. Physical presence at your primary residence is fairly easy to document, utilizing calendars, planners, plane tickets, EZ Pass records, canceled checks, and credit card and other receipts. But how do you document intent? The answer provided by the Court, as well as Maine Revenue Services, is: look to the actual facts and circumstances of each particular case for indications of a person's understanding and intent with regard to his or her residency. In our experience, the most important indicia of intent tend to be the following:

1. If your new state of domicile allows for the filing of a declaration or affidavit of domicile (as Florida does), make sure you complete and file such a form as soon as you can.
2. If you are entitled to a homestead exemption and/or a Veteran's exemption with regard to your home in the new state, apply for those benefits as soon as possible. Since such benefits are typically available only to residents domiciled in the state, you will have to give up those benefits in Maine by contacting the local town assessor. If you fail to do so, Maine Revenue Services may argue that you are still domiciled in Maine for tax purposes.
3. Register to vote in the new state, obtain a new driver's license there, and register your motor

vehicles there. This means giving up your voter registration, driver's license and motor vehicle registrations in Maine.

4. List your new non-Maine address as your primary address for all billing and correspondence, and as your address on all tax returns. If you retain a residence in Maine, it must be treated as a vacation or summer home only, and never as a primary address.

5. Similarly, your address recorded for insurance policies, deeds, mortgages, and other legal documents should be your new primary residence address, and not your Maine summer address. Any legal document signed by you after your change of domicile should reflect your residence in that new state.

6. If you obtain a hunting or fishing license in Maine, make sure you do so as a nonresident. If you apply for such a license as a resident, that could be construed as a statement of intent to change your domicile back to Maine!

7. If you have a safe deposit box, it should be located in your new state of domicile and not in Maine.

8. The same applies to banks, investment firms, and professionals with whom you do business. To the fullest extent feasible, these should all be in your new state of domicile. It is fine to maintain a relationship with a Maine physician if you spend your summers in Maine, but you should also have a doctor (and a lawyer and accountant) in your new state after moving from Maine.

   a. Maine now has a statutory provision which expressly **prohibits** using the geographic location of a person's professional advisors for determining domicile for income tax purposes.

   b. But there is no such express prohibition in determining domicile for **estate tax** purposes.

9. Fraternal, social and athletic memberships should also reflect your move from Maine to the new state. The same applies to your religious activities. They should now focus on a church, synagogue, or other house of worship in the new state rather than Maine.

10. Charitable donations should reflect charities in your new state of domicile. This does not mean you have to stop giving to Maine charities, but your charitable giving should reflect a change of your focus from Maine to the new state.

11. Where you keep your pets, where and how you do business, and where you maintain professional licenses can all be seen as indicia of your intent with regard to domicile. Be careful not to have any of these reflect primary residency or focus in Maine.

12. It is generally a good idea to have some or all of your estate planning documents updated in your new state. This is particularly true of powers of attorney and health care directives, which should be in a form familiar to third parties in that new state.

A decedent's domicile in a state other than Maine will determine the extent to which his or her estate may be subject to some Maine estate tax. Maine estate tax rules will still apply to Maine real and tangible property as explained in the article above. But a living person's domicile does not necessarily determine that person's status as a resident or nonresident for state **income tax** purposes. This is because Maine has "statutory resident" provisions in its income tax statute which treat persons clearly domiciled elsewhere as Maine residents for income tax purposes if certain tests are met. For instance, a Florida resident with a summer home in Maine who "did all the right things" with regard to the twelve planning points listed above, but spent more than 183 days (including portions of a day) in Maine during a particular calendar year, will be treated as a Maine resident that year for state income tax purposes. If you have any questions about residence and domicile, please feel free to contact any of us or your accountant for guidance in navigating these potentially tricky tax provisions. ■

DID YOU KNOW?

- For 2009, the gift tax annual exclusion will increase to $13,000. This means that the first $13,000 of gifts to any person (other than gifts of future interests in property) will not be included in the total amount of taxable gifts made during the year.
- The amount that one may give to a **non-citizen** spouse is increasing to $133,000 in 2009.
- The maximum income tax credit allowed for adoption of a child will increase to $12,150 in 2009.

WHAT STRATEGIES ARE WORTH CONSIDERING IN THIS ECONOMIC CLIMATE?

The value of publicly traded securities has plummeted. Interest rates are low. Are there strategies that are attractive in this unusual economic climate?

Roth IRA Conversion. It may be worthwhile to consider converting a conventional IRA, or part of one, to a Roth IRA. Amounts in a traditional IRA can be converted into a Roth IRA only if the taxpayer's adjusted gross income for the year is less than $100,000 and the taxpayer is not married filing separately. The rolled over or converted amount must be included in gross income for the year of the conversion, but does not count as part of the $100,000 adjusted gross income limit. Roth IRAs are not subject to the minimum required distribution (MRD) requirements that apply generally to qualified plans and traditional IRAs. Unlike traditional IRAs, distributions from Roth IRAs are generally not subject to income tax, although distributions within the first five years after a Roth IRA conversion may be subject to the 10 percent penalty on early distributions if the account holder has not attained age 59 ½. After the account holder's death, the MRD rules apply so that distributions must commence to the designated beneficiary; but, the distributions continue to be free of income tax. In short, Roth IRAs are attractive. They grow tax free, and distributions are generally tax free. However, they must be funded with after-tax money, so the conversion of a traditional IRA exposes the assets to income tax. Given that asset values are currently low, the tax cost would be less now than it has been for years.

How About a GRAT? For people who will continue to have estates with exposure to federal estate taxes after the $3.5 million exemption takes effect in January, it may be worthwhile to consider a grantor retained annuity trust (GRAT). A GRAT is an irrevocable trust to which a grantor transfers property as a gift, but retains an annuity interest for a term of two or more years. At the end of that term, the trust can continue for the benefit of, or can be distributed outright to, one or more designated beneficiaries. The value of this gift to the designated beneficiaries for gift tax purposes is the fair market value of the property transferred to the trust (the original value), reduced by the value of the grantor's retained interest (the retained interest value) determined as of the date the trust is funded. The rules for determining the retained interest value are complicated and beyond the scope of this brief article. They take into account such things as the level of the grantor's annuity, a presumed rate of return on the transferred property (published monthly by the IRS), and whether or not the designated beneficiaries are family members. The bottom line, however, is that when interest rates are low (which affects the IRS-approved rate of return) and the transferred property has high appreciation potential, a transfer to a GRAT can be made at a relatively low gift tax value (using up a small portion of the grantor's $1 million exemption), with the designated beneficiaries receiving the transferred assets a few years later, at the end of the retained annuity term, with a total value (including all appreciation) which is significantly higher than the value of the gift reported on the grantor's gift tax return. In times like these when interest rates are relatively low, and when market values are very low but some assets may have significant appreciation potential, utilization of a GRAT might be an attractive technique for leveraging substantial gifts to younger beneficiaries with a relatively modest impact on the grantor's lifetime gift tax exemption. ■

"Ed, this is Art Simbley over at Hollis, Bingham, Cotter & Krone. What did you get for thirty-four across, 'Persian fairy,' four letters?"