Medical Economics
September 10, 2011

Protect more of your assets from the estate tax

The law now allows your spouse to take advantage of your unused estate tax exemption

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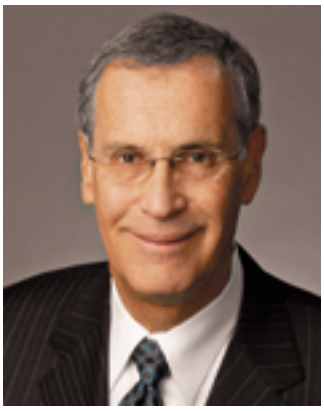

By now, most people concerned about estate taxes understand the basic provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Effective January 1, 2011, the estate tax applicable exclusion amount became $5 million, and the top tax rate became 35%. The law also includes changes to the gift tax laws and the generation-skipping tax laws.

What you may not know, however, is that the 2010 act provides a means for doctors and other professionals to protect their assets from creditors or malpractice claims without incurring negative estate tax implications. It also contains what amounts to a marriage tax.

Also new are the portability provisions under Section 303 of the 2010 act. This section allows a surviving spouse to use the exclusion amount not used by the estate of a deceased spouse. In plain English, this means that if my wife holds all of my family's assets, and I die, I will not have used any of my $5 million exclusion amount.

In the past, by contrast, I would have lost the benefits of the exclusion amount that my estate did not use. For example, if the exclusion amount were $3.5 million and my estate was valued at $2 million, at my death, the remaining $1.5 million exclusion amount would be lost forever.

This situation would be particularly bad if my wife's estate, upon her death, exceeded the exclusion amount. Remember, her estate will be increased by everything I leave her. In such a case, her estate would incur significant taxes because our assets were not evenly divided, thereby causing my estate to lose part, if not all, of my exclusion amount. As a result, estate-planning professionals created trusts in which an amount equal to the exclusion amount would be placed in a family trust for the benefit of the spouse and would not be taxable in the

spouse's estate at death. This was a major selling point in convincing clients to establish trusts.

IMPACT OF NEW PORTATIBILITY PROVISIONS

With the new portability provisions in the 2010 act, you no longer need a trust to maximize the exclusion amount. In the aforementioned scenario, under the 2010 act, the $1.5 million unused exclusion amount will not be lost. Instead, it will be added to my wife's exclusion amount, giving her an exclusion amount of $6.5 million upon her death. Further, no trust is needed to accomplish this exclusion increase.

This change is significant for doctors and other professionals who can be sued personally for professional liability. It means you can transfer all of your assets to your spouse without incurring any negative tax consequences. Previously, if you wanted to make yourself "creditor proof" by transferring everything to your spouse, you would lose all your exclusion amount.

With estate tax rates as high as 60% in 2009, this situation could be prohibitively expensive. As a result, many doctors obtained professional liability insurance and prayed it would be enough if a problem arose. Now, however, you can just transfer all of your assets to your spouse without worrying about the estate taxes.

Of course, nothing is ever that easy. What if you get divorced or if your spouse predeceases you? Unfortunately, you cannot control whether you die before your spouse. Before you give everything to him or her, you should be comfortable with your marriage, or enter into a postnuptial agreement, that will control the distribution of your assets in the event of your death or a divorce. In such a case, as stated previously, your spouse will have a $10 million exclusion amount at his or her death (your $5 million and your spouse's $5 million.)

IF YOUR SPOUSE REMARRIES

What if your spouse chooses to remarry? Congress contemplated the myriad scenarios that could arise as a result of multiple marriages, divorces, and deaths, and decided to simplify the law. Simply put, a decedent's estate will be entitled to the exclusion amount of the decedent's last deceased spouse. In other words, if the deceased doctor's spouse remarries and then outlives the second spouse, he or she only would be entitled to the exclusion amount that the second deceased spouse had remaining.

For example, if I die and everything is in my wife's name, then my wife would be entitled to a $10 million exclusion amount. If my wife remarries a man who dies without using his exclusion amount, then my wife's estate still would be entitled to the $10 million exclusion. However, if my wife marries a man who dies using his

entire $5 million exclusion, leaving my wife with none of his exclusion amount, then my wife only would be entitled to her own $5 million exclusion.

In this case, her estate is not able to take advantage of my $5 million exclusion because her estate is only entitled to the remaining unused exclusion amount of her last deceased husband. Since the last deceased husband had no exclusion amount remaining, my wife's estate has lost the opportunity to use my $5 million exclusion amount.

RETAINING THE FULL EXCLUSION AMOUNT

What can my wife do under such circumstances? First, she can give away an amount equal to my unused exclusion amount before her second husband dies. Unless my wife is very wealthy, however, she may be reluctant to make major gifts under such circumstances.

Alternatively, she may remarry a man without a large estate or not marry the wealthy man—just live with him. If she does not marry the wealthy man, she retains my unused exclusion amount, meaning that her $10 million exclusion amount remains intact. In essence, our government now is requiring a wealthy widow (or widower) to remain unmarried if he or she wishes to avoid what is tantamount to a marriage tax on the estate—a tax for not remarrying.

If my wife remarries after my death and then divorces the second husband, nothing would change. She would still be entitled to the unused exclusion amount of the last deceased husband (me), not the last husband. Under these circumstances, therefore, my wife will need to divorce her second husband before he dies to retain my exclusion amount.

ADDITIONAL PROVISIONS

The 2010 act includes a few additional provisions of which you should be aware. To enable the surviving spouse to use the decedent's unused exclusion amount, the decedent's estate must affirmatively elect to allow the surviving spouse to use it. If the decedent's estate is small—such that no estate tax return is needed—will anyone remember to ask the representative of the decedent's estate about the election? Probably not. If the surviving wife is a second spouse for the decedent, will the decedent's family members even think about the surviving wife when they settle the decedent's affairs? What if their offspring don't get along?

If the wife in the examples above dies before the second husband, can the surviving husband use the remaining exclusion amount of the deceased wife that she received from her deceased first husband? No. The 2010 act does not allow the exclusion amount to pass from a deceased husband's estate to the estate of the second husband after the surviving wife dies.

EXAMPLES OF THE NEW LAW IN ACTION

The staff of Congress' Joint Committee on Taxation has provided three examples which do a good job of illustrating what the law intended[1]:

Example 1—Assume that husband one dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on husband one's estate tax return to permit his widow to use husband one's deceased spousal unused exclusion amount.

As of husband one's death, his widow has made no taxable gifts. Thereafter, her applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus the $2 million deceased spousal unused exclusion amount from husband one), which she may use for lifetime gifts or for transfers at death.

Example 2—Assume the same facts as in example one, except that the widow subsequently marries husband two. Husband two also predeceases the woman, having made $4 million in taxable transfers and having no taxable estate. An election is made on husband two's estate tax return to permit the widow to use husband two's deceased spousal unused exclusion amount.

Although the combined amounts of the unused exclusions of husbands one and two is $3 million ($2 million from husband one and $1 million from husband two), only husband two's $1 million unused exclusion is available for the widow to use, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, husband two's $1 million unused exclusion).

Thereafter, the widow's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus the $1 million deceased spousal unused exclusion amount from husband two), which she may use for lifetime gifts or for transfers at death.

Example 3—Assume the same facts as in examples one and two, except that the woman predeceases husband two. Following husband one's death, the widow's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus the $2 million deceased spousal unused exclusion amount from husband one.)

The widow made no taxable transfers and has a taxable estate of $3 million. An election is made on her estate tax return to permit husband two to use her deceased spousal unused exclusion amount, which is $4 million (her $7 million applicable exclusion amount less her $3 million taxable estate.)

In this example, the amount of the unused deceased wife's exclusion amount available to the second husband is the excess of the "basic exclusion amount" (which is $5 million) in excess of her taxable estate. In other words, the widow's basic exclusion amount is $5 million less her taxable estate of $3 million, which leaves husband two with $2 million of his deceased wife's exclusion amount. (Note: examples have been paraphrased.)

For protection against creditors and malpractice lawsuits, you may wish to consider transferring all assets to your spouse, but be aware that if your surviving spouse wishes to maximize the estate's exclusion amount, he or she either must:

- remain unmarried for the rest of his or her life;
- divorce the dying second spouse if he or she has a lower exclusion amount than the first spouse; or
- give away his or her prior deceased spouse's unused exclusion amount.

The alternative is to incur the greater tax on his or her estate. The good news is that now, at least, we have a choice.

REFERENCE

Technical explanation of the revenue provisions contained in the Tax relief, unemployment insurance reauthorization, and job creation act of 2010, H.R. 4853, 111th Cong., 2nd Sess (2010), prepared by the staff of the Joint Committee on Taxation at pp. 52-53, December 10, 2010 (JCX-55-10).

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