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COMMON TAX OPTIONS TO REDUCE/AVOID FEDERAL ESTATE TAX

Generally there are three commonly used ways to reduce or eliminate federal estate tax, otherwise generally payable within nine months of death of a person whose estate is valued in excess of \$5,000,000 if death occurred in the year 2012. The first way, and the one that is most commonly utilized, is the so-called “marital deduction,” which under current law means that a person can leave his or her entire estate to his or her spouse without incurring any federal estate tax, even though such person’s estate exceeds \$5,000,000. The second way is to take advantage of the deduction against tax allowed for charitable gifts. The third, and lesser-known way, is what has been commonly referred to as the “applicable exclusion amount,” formerly called the “unified credit exemption.” This is the amount of an estate which is exempt from federal estate tax even if such property passes to someone other than a spouse. The amount of the exemption increased gradually until, in the year 2010 the estate tax statute was “repealed.” The 2011 Tax Relief Act which was signed into law on December 17, 2010, provides a \$5,000,000 federal exclusion for 2011 and 2012. Presently there is no Oklahoma estate tax. Absent a change in the estate tax law by Congress, the applicable exclusion amount will automatically drop from \$5,000,000 to \$1,000,000 beginning January 1, 2013. The current status of the federal and Oklahoma exemptions are charted below:

In the case of estate of decedents dying during:	The applicable federal exclusion amount is:	The current applicable Oklahoma exclusion amount is:
2001	\$ 675,000	\$ 675,000
2002	\$1,000,000	\$ 700,000
2003	\$1,000,000	\$ 700,000
2004	\$1,500,000	\$ 850,000
2005	\$1,500,000	\$ 950,000
2006	\$2,000,000	\$1,000,000
2007	\$2,000,000	\$1,000,000
2008	\$2,000,000	\$2,000,000
2009	\$3,500,000	\$3,000,000
2010	Repealed	Permanently Repealed
2011	\$5,000,000	
2012	\$5,000,000	
2013	\$1,000,000	

Nearsighted Error. A very common oversight with many families is that the person first to die usually leaves (by way of a simple Will, joint tenancy, life insurance, IRA, beneficiary designation, etc., or even a revocable trust) his or her entire estate to his or her spouse which, as mentioned above, does not result in any federal estate tax. However, upon the death of the surviving spouse (assuming the spouse has not remarried), if the total estate value of the surviving spouse exceeds the applicable exclusion amount then available (after other deductions such as charitable gifts, debts, taxes, etc.), the estate may incur federal estate tax. Due to the federal estate tax being rather aggressive, there is a significant estate tax danger to even medium-sized estates. Assets such as a person's house, IRAs, pensions or other funds, stocks, bonds, automobiles, collectibles, and even life insurance, if owned by the decedent, together may easily exceed the exemption amount. However, with some relatively simple planning and farsighted thinking, it is possible for a couple to pass up to \$10 million (for years 2011 and 2012), to their children or other beneficiaries without any federal or state estate tax liability. This is done through utilizing the so-called exemption equivalent trust or more commonly known as a "bypass" trust or "credit" trust.

Compulsory Bypass Trust. One simple approach in order to make use of the current exemption available to each person, is for the person first to die to have established in his Last Will or Living Trust a so-called bypass trust which is designed to receive or hold up to the exempt amount of assets. The surviving spouse is given the right to receive all income and principal, if needed, from the bypass trust in order to provide for the "support, health, maintenance and education" of the surviving spouse. The surviving spouse may even be trustee of the bypass trust, solely or with another person or professional Trustee, or another person or corporate trustee may serve alone. The bypass trust is technically subject to federal estate tax upon the first death, but as long as it does not contain assets valued at more than the exempt amount, no actual federal estate tax will be incurred, due to the credit (exclusion) available. At the second death, the bypass trust established in the first spouse's Will or Trust document is not "retaxed." It was subject to tax at the first death but, as mentioned above, no actual federal estate tax was incurred, because of the credit. Upon the death of the surviving spouse, the will/trust provides for final distribution of all remaining assets in the bypass trust to those persons chosen by the spouse first to die. If the surviving spouse's own separate estate likewise does not exceed the exempt amount of assets, there will be no federal estate taxes upon the surviving spouse's death. Thus, it is possible to pass a total of assets equal to twice the applicable exclusion amount from the combined assets of both spouses to the heirs or other beneficiaries of the husband and wife, free of federal estate tax.

Disclaimer Option. Because some individuals may feel insecure with the first spouse creating a bypass trust without the surviving spouse having any say so in the matter, it is possible to create a so-called "empty" bypass trust in the will or trust of the first spouse to die, granting to the surviving spouse the right to determine whether or not to fund (i.e., to authorize assets to be transferred into) the bypass trust. We call this a "disclaimer funded" bypass trust. It works quite simply. The spouse first to die leaves his/her entire estate to the surviving spouse; however, the surviving spouse is given a right to "disclaim" or refuse to accept all of the property coming to him or her from the estate of the deceased spouse. Whatever property is disclaimed, be it specific property, or a percentage or fractional portion of property, passes into the bypass trust and remains there throughout the life of the surviving spouse. However, as mentioned above, the surviving spouse is entitled to receive all income and principal, if necessary, for the purpose of support, health, maintenance and education. The disclaimer funded approach provides flexibility, but there is increased risk that if the surviving spouse fails to disclaim, then all assets will pass to the surviving spouse, thus possibly "overloading" the surviving spouse's estate, and triggering or increasing the federal estate tax upon the second death.

If the surviving spouse remarries and thus makes an alternative distribution plan with all the assets (*i.e.*, the assets received from the first spouse to die as well as the surviving spouse's assets), the children of the spouse first to die may be, inadvertently or even intentionally, disinherited by the surviving spouse. In order to protect the children of the first spouse to die, it is possible to utilize the compulsory funded bypass trust (as previously explained above), with an independent trustee to insure that, upon the surviving spouse's death, all property then remaining in the bypass trust will pass to the descendants or other beneficiaries named in the trust of the spouse first to die.

Qualified Terminable Interest Property Trust. An additional alternative to passing all property to the surviving spouse, is what is called a "qualified terminable interest property trust." This type of trust, commonly called a "QTIP" trust, is designed to give the surviving spouse all income earned by the trust during the surviving spouse's lifetime, payable at least annually, and, may provide for principal distributions to maintain the surviving spouse as needed for support, maintenance, health and education. However, a QTIP trust allows the person first to die to name the final beneficiaries of the trust as to that property remaining in it at the death of the second spouse. A QTIP, if used, is often put into place along with a bypass trust to hold property in excess of the exempt amount. QTIP property is often taxed in the surviving spouse's estate, but contains provisions which allow the person first to die to control the ultimate distribution of the remaining property after the death of the surviving spouse.

"Portability" of the Applicable Exclusion Amount. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 signed by President Obama on December 17, 2010, contained a provision granting the surviving spouse of a deceased couple the right to apply to his/her own estate, the unused applicable exclusion amount that otherwise was available to the spouse first to die. This in effect enables the second spouse to die to potentially increase his/her own applicable exclusion amount by the "leftover" or unused portion of the applicable exclusion amount available to the predeceasing spouse. This may seem to provide some benefit to couples who fail to implement more complete estate plans. However, currently this new provision remains in effect until December 31, 2012 unless extended by Congress, and there are certain filing requirements to make the portability election. Other factors may make this option less-than-desirable for some couples than a more careful and complete estate and tax plan.

This brief article does not fully explain the intricacies of these various trust/tax options. It is designed to give you an overview of these more common options for the purpose of further inquiry. There are numerous other more sophisticated tax planning options available which may be of use in your particular financial and estate plan. Please feel free to contact us for further discussion of these and other various options so that the options most suitable to your personal estate planning needs are selected.

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