ESTATE TAX LAW UPDATES

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1. Minnesota Estate Tax Update 12/20/2010

The President and GOP have brokered a deal, but there is some push back by the lame duck Congress. Much has been in the news about the federal estate tax changes. It is uncertain yet whether Congress will act to prevent the estate tax personal exemption from automatically returning to $1 million on January 1, 2011 with a maximum rate of 55%. Without legislative action, this will occur resulting in a tax increase for many estates.

Changes have also occurred in the state of Minnesota though they have received much less attention. Newly enacted legislation will significantly increase the amount of estate tax collected by Minnesota from the estates of persons who use qualified terminable interest marital trusts (QTIP Trusts, described below) to leave property to surviving spouses.

While this is presently effective only for deaths in 2010, we think in light of state budget shortfalls that this tax increase will remain in effect-possibly in a somewhat modified form in future years. The legislation was unexpected.

The estates affected by this legislation are the estates of married persons who (i) have taxable estates greater than $1 million and (ii) have estate plans that leave a portion of the first deceased spouse's estate in a QTIP Trust. The tax increase to an estate which exceeds $3.5 million in value will generally not be greater than $229,200[1]. The increase will be less for estates greater than $1 million but below $3.5 million. The change will not affect anyone whose estate is less than $1 million, or does not employ a QTIP Trust in his/her estate plan. To avoid an estate tax on the death of the first spouse, all affected estate plans need to be revised.

(a) Background

The estate tax marital deduction applies to persons who leave property at death either outright or in a qualifying marital trust for a surviving spouse. A QTIP Trust is the only type of trust qualifying for the estate tax marital deduction in which the deceased spouse can direct how the trust property will be distributed on the death of the second spouse. QTIP Trusts are frequently used in second marriages, to protect the inheritance of descendants, and to protect trust property from predators and creditors of the surviving spouse (including a future spouse). QTIP Trusts can yield significant tax savings when clients own valuable family businesses, or have larger estates, and are trying to protect family wealth for multiple generations through the use of generation-skipping tax planning.

A common format for an estate plan that uses a QTIP Trust is to leave the largest amount that can pass without the payment of Minnesota or federal estate tax into a trust for the surviving spouse and descendants. This trust is frequently called a family trust.[2] The remainder of the property passes into a QTIP Trust.

(b) Example Illustrating the Increase in the Minnesota Estate Tax

[redacted] Federal estate tax legislation contains an exemption greater than the $3,500,00 exemption that applied when the Federal estate tax lapsed at the end of 2009.

[2] In some estate plans, it is called a "B" Trust, a "Credit Trust" or a "Bypass Trust".

If a Minnesota resident died in 2009 with (i) an estate worth $4 million (having made no prior taxable gifts for which a gift tax return was required), (ii) a surviving spouse, and (iii) a Family Trust and a QTIP Trust, the Family Trust would be funded with $1 million, and the QTIP Trust would be funded with $3 million. No federal or Minnesota estate taxes would be due.

For persons who die in 2010, the legislation provides that the marital deduction for transfers to QTIP Trusts will be permitted only to the extent that the deduction is claimed on the deceased person's Minnesota estate tax return for the portion of his/her estate that exceeds $3.5 million in value. In this example, the Minnesota estate tax on the nondeductible portion, i.e. the estate's value between $1 million and $3.5 million, would be $229,200.

(c) Should Estate Plans with a QTIP Marital Deduction be Revised?

As a result of these changes, the automatic funding of QTIP Trusts should be eliminated from many, but not all, estate plans. While some families will benefit from paying an estate tax to Minnesota on the death of the first spouse, if doing so is likely to significantly reduce estate taxes payable on the death of the second spouse, many clients do not want to pay estate taxes at the first spouse's death. Frequently, however, the decision to pay an estate tax on the death of the first spouse will depend on a number of factors, including (i) the value of the deceased spouse's estate, (ii) the federal and state tax rules in effect on the death of the first spouse, (iii) the liquidity of the deceased spouse's estate, (iv) the surviving spouse's age and anticipated life expectancy, (v) the best guess as to the size of the surviving spouse's future estate, and (vi) the federal and state estate tax rules that will be in effect on the death of the second spouse. Since decisions of this kind are best made as late as possible (when facts and future tax rules are more predictable), many people will choose to eliminate the automatic funding of a QTIP Trust at death.

If you would like to schedule an office conference to discuss the specific implications of this law change on your estate plan, please contact Craig Howse at chowse@howselaw.com.

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