2005 YEAR IN REVIEW

"Progress might have been alright once, but it has gone on too long."

- Ogden Nash

AN OVERVIEW

Over the last several years we have seen a steady evolution of estate planning techniques, tools and opportunities as a result of both state and federal legislative changes. Calendar year 2005 was no different.

- The Maine legislature, responding to requests from Maine estate planning lawyers, created a means for us to plan more efficiently for both Maine and federal estate taxes.
- As of July 1, the Maine Uniform Trust Code became effective, providing us with new planning flexibility.

Also new for 2005: Although not within the categories of new estate planning techniques, tools or opportunities, the IRS imposed new rules that affect how estate planning attorneys, accountants and other tax professionals communicate with their clients.

And finally, widely anticipated changes in the federal estate tax have not yet occurred . . . although they are still expected.

THE MAINE ESTATE TAX

First, a little review. Before 2003, Maine residents didn't pay a separate Maine estate tax when they died. If a Maine resident died and owed federal estate tax, the U.S. Treasury shared a portion of the federal estate tax it collected with the State of Maine. In other words, before 2003, although estate taxes might have been paid to the State of Maine, the payment didn't cost the decedent's estate any extra money. What was paid to Maine came out of the U.S. Treasury's pocket.

Under the Economic Growth and Tax Relief Reconciliation Act passed by Congress in 2001, Maine saw the beginning of a four year phase out of its share of federal estate tax revenues. As of January 1, 2005, Maine was cut off completely from receiving any of the federal estate tax paid by a deceased Maine resident.

To deal with the decline of federal estate tax revenue sharing, Maine created its own estate tax in 2003, and established, independent of the federal estate tax system, the amount that each person may leave on death to his or her heirs free of Maine estate tax (in our office, we refer to the amount that each person may leave to his or her heirs free of estate tax, as the "coupon amount"; in Internal Revenue Code parlance, it is called the "applicable exclusion amount").

The Maine estate tax coupon is pegged to the old federal coupon that existed before Congress passed the 2001 Tax Act. In 2005 the Maine coupon was $950,000. As of January 1, 2006, the Maine coupon is $1 Million and it is not scheduled to increase beyond $1 Million in future years.

In contrast, as of January 1, 2006, the federal coupon is $2 Million. Under the 2001 Tax Act, the federal coupon is:

2002 – 2003	-	$1 Million
2004 – 2005	-	$1.5 Million
2006 – 2008	-	$2 Million
2009	-	$3.5 Million
2010	-	Unlimited (estate tax "repeal")
2011+	-	$1 Million

By creating its own estate tax system and a coupon amount that is no longer linked to the federal coupon, Maine has "decoupled" from the federal estate tax structure. Under the Maine estate tax system, and as a result of the Maine coupon being $1 Million when the federal coupon is $2 Million, there is a Maine estate tax *in addition to* the federal estate tax, and there will be many times when a Maine estate tax is due even though there is no federal estate tax due. Maine is not alone in having decoupled from the federal estate tax system. Approximately 16 other states have done something similar to Maine in order to recoup the estate tax revenue sharing that was lost as a result of the federal 2001 Tax Act.

Here's the effect of a Maine coupon that is smaller than the federal coupon: Under most estate plans for married couples, the Will or Revocable Living Trust creates a Family Trust and a Marital Trust at the death of the first spouse. The formula for determining the amount of assets used to fund each trust typically says that the Family Trust receives the federal coupon amount and the Marital Trust receives the balance of the assets. For example, if husband dies in 2006 with $2.5 Million of assets, under the formula, $2 Million of husband's assets would go to the Family Trust and $500,000 would go to the Marital Trust. There were two purposes for the formula and the creation of the Family Trust and Marital Trust: first, to ensure that no estate tax was due at the time of the first to die of husband and wife, and second, to take maximum advantage of each spouse's federal coupon amount. With Maine having "decoupled" from the federal estate tax, what we and our clients expected would be the estate tax result at the first death (that no tax would be due) is no longer an accurate expectation.

With a Maine coupon of $1 Million, a federal coupon of $2 Million, and a formula in the Will or Revocable Trust that says to fund the Family Trust with the amount of the federal coupon at the time of the first spouse to die, if the first spouse to die has $2 Million of assets available to fund the Family Trust, **there will be a Maine estate tax of $99,600 at the first spouse's death unless amendments are made to the Will or Revocable Living Trust.** It gets worse. In 2009, when the federal coupon increases to $3.5 Million, if the formula in the Will or Revocable Trust says to fund the Family Trust with the amount of the federal coupon at the time of the first spouse to die, and the first spouse to die has $3.5 Million of assets available to fund the Family Trust, **there will be a Maine estate tax of $229,200 at the first spouse's death unless amendments are made to the Will or Revocable Living Trust.**

Last year in our *Year in Review* we said that it might make sense, depending on the size of the total combined estate of a married couple, to amend an existing Will or Revocable Living Trust and change the formula to limit the amount used to fund the Family Trust to the amount of the Maine coupon. Doing so would have ensured that there would be no estate tax paid at the time of the first spouse to die. As of last year when we wrote our 2004 *Year in Review*, limiting the amount used to fund the Family Trust at the first spouse's death to the amount of the Maine coupon might have saved $99,600 in Maine estate tax for a death in 2006, but the savings at the first death came with a potentially expensive trade-off. By limiting the amount used to fund the Family Trust to the amount of the 2006 Maine coupon, a married couple would have wasted $1 Million of the federal coupon of the first spouse to die (remember, the federal coupon in 2006 is $2 Million; the Maine coupon is $1 Million). As a result, the surviving spouse's estate might have paid as much as $359,080 of additional estate tax that could have been avoided entirely if $99,600 of Maine estate tax had been paid at the first spouse's death. The choices were not very attractive: pay $99,600 of Maine estate tax at the first death, or pay $359,080 of additional estate tax at the death of the surviving spouse.

That was the unattractive choice that people faced when we wrote our 2004 *Year in Review*. No longer. Thanks to a beneficial change made by the Maine legislature in 2005, the tax dilemma described in the previous paragraph no longer exists. With an appropriate amendment to the Wills or Revocable Living Trusts of a married couple, we can still ensure that there will be no estate tax paid at the first spouse's death **and** avoid wasting any of the federal estate tax coupon of the first spouse to die. **It is important**

that your Will or Revocable Trust be amended to accomplish the tax savings. Failure to update your estate planning documents will result in the payment of a Maine estate tax of $99,600 if the first spouse's death occurs in 2006, 2007 or 2008 and the deceased spouse has assets of $2 Million or more.

The increase in the federal coupon to $2 Million, combined with a $1 Million difference between the Maine and federal coupons as of January 1, 2006, makes a review of your existing estate plan essential to determine whether it should be updated.

For married couples with estates of less than $1 Million, or even with slightly more than $1 Million, who had their estate planning documents created or last updated when the federal coupon amount was somewhere between $600,000 and $675,000, it may be worth considering amending your estate plan to eliminate the creation of a Family Trust entirely. In most estate plans, the Family Trust is created at the death of the first spouse solely to permit estate tax savings at the death of the surviving spouse. For a married couple with an estate of $1 Million, estate tax planning was an integral part of the estate plan when the federal coupon amount was $675,000. Fortunately, a $1 Million estate is no longer subject to Maine or federal estate tax, so, for simplicity, it may make sense for a couple with an estate that doesn't exceed $1 Million± to amend the estate plan to eliminate the creation of a Family Trust at the first spouse's death. In some cases, however, in spite of the fact that the Family Trust may no longer be needed for estate tax planning purposes, there may be valid non-tax reasons to retain the Family Trust as part of the overall design of the estate plan. Creating a Family Trust can provide creditor and divorce protection for the surviving spouse and assurance that the Family Trust assets will pass to designated beneficiaries (for example, children from a prior marriage) at the death of the surviving spouse.

Although the above explanations refer to married couples, many of the issues are equally applicable to unmarried partners.

As much now as ever before, estate planning is an intensely personal process. One size does not fit all. We will be happy to discuss with you all the options available to address planning for the Maine estate tax.

THE FEDERAL ESTATE TAX

The status of the federal estate tax is unchanged from our 2004 *Year in Review*. The absurdity of the 2001 Economic Growth and Tax Relief Reconciliation Act still exists.

Under current law, the federal coupon amount (the amount of assets that are exempt from federal estate

tax when leaving assets to anyone other than a U.S. citizen spouse) is $2 Million in 2006, 2007 and 2008, will increase to $3.5 Million in 2009, will be unlimited in 2010 (the year of estate tax "repeal"), and then revert to $1 Million in 2011 and beyond. President Bush has been clear about his desire to see the repeal be made permanent (rather than merely be a 1 year phenomenon). More than once in 2005 the White House spearheaded efforts to muster the 60 votes required in the Senate to make the repeal permanent. On each occasion, there were insufficient votes to do so. The debate over repeal of the federal estate tax continues to be as much philosophical as fiscal, as much about social engineering as generating revenue, and as highly politicized as ever.

With the country still trying to figure out how to finance staggering budget deficits, our prolonged presence in Iraq, the global war on terrorism, homeland security, anticipated shortfalls in Social Security, Medicaid, Medicare, and a national drug benefit program, skeptics continue to question whether the country can economically or philosophically justify tax cuts that would permit vast wealth to pass from generation to generation without tax.

Rather than making the repeal permanent, we hear a lot of discussion about the possibility of Congress increasing the federal coupon to $4 Million or so, and perhaps indexing it to inflation. Whether, and when, that may happen . . . stay tuned. Whether anything will happen before the next round of Congressional elections in November 2006 is anyone's guess.

In the meantime, it is essential that you review your estate plan on a regular basis to ensure that your planning goals are not unexpectedly frustrated by the changing estate tax environment.

THE FEDERAL GIFT TAX

Although the federal *estate* tax coupon (for transfers on death) increased to $2 Million on January 1, 2006, the federal *gift* tax coupon (for lifetime transfers) remains at $1 Million. In other words, *lifetime* transfers in excess of $1 Million (or $2 Million for a married couple) will result in the payment of a federal gift tax.

Since 2002, the annual gift tax exclusion amount has been $11,000. Before that it was $10,000. As of January 1, 2006, the annual gift tax exclusion increased to $12,000 and permits a person to give $12,000 a year to as many recipients as desired, without eroding the lifetime gift or death coupon amount.

Maine has no gift tax.

THE MAINE UNIFORM TRUST CODE

On July 1, 2005, the Maine Uniform Trust Code (UTC) took effect. The UTC provides a

comprehensive body of law governing the creation and administration of trusts, the duties of trustees and the rights of beneficiaries, and fills in many gaps that previously existed in Maine law.

As we noted in our 2004 *Year in Review*, a significant addition that the UTC makes to Maine law is the degree of creditor protection that it provides to trust beneficiaries.

There are a myriad of reasons why a trust may be beneficial in any particular circumstance - - estate tax planning; to ensure that a beneficiary's needs of education, health and support are provided for during periods of minority or incapacity or when the beneficiary is otherwise unable to wisely use and manage his or her own assets; to provide for the lifetime care of a beneficiary and then be assured of having the assets be distributed to or held in continued trust for one or more additional beneficiaries; to protect a beneficiary's entitlement to government benefits (Medicaid or SSI); or to provide creditor and "predator" (*i.e.*, divorce) protection for a beneficiary.

The UTC clarifies that a creditor cannot reach the trust assets even if the beneficiary is the sole trustee of the trust, as long as the trustee's distribution discretion is limited to amounts required for the beneficiary's education, health, maintenance and support. The significance of this clarification for our clients is that we can now safely design trusts to permit a beneficiary to be the sole trustee of the beneficiary's trust and not fear a loss of creditor/predator protection. Permitting the trust beneficiary to serve as sole trustee will not be appropriate in all cases. It will never be appropriate when one of the reasons for creating the trust is to protect the beneficiary from his or her own improvidence or inexperience or to ensure that the trust assets are available to provide for the beneficiary's education, health and support until the beneficiary attains a certain age. But, if your inclination is to leave assets to a loved one outright and free of trust because he or she is experienced and responsible enough to prudently manage his or her own assets, the better planning option in virtually all such circumstances is to leave the assets in trust with the beneficiary as the sole trustee of the trust. The beneficiary will have full control of the assets but will have the protection and peace of mind of knowing that the assets are protected from his or her creditors. The trust is not likely to be "bullet proof", especially if the beneficiary files bankruptcy, but it will provide a protective shield that would not otherwise be available to deter creditors and protect the beneficiary's trust assets.

The UTC also permits us to avoid providing beneficiaries with information about the existence of the trust when non-disclosure is desirable. For example, if you create a trust for your child, designating that at your child's death the trust assets will go to your grandchildren, you may not want your trustee to provide annual trust reports to your grandchildren during your child's lifetime. Similarly, if you create a trust for your spouse, you may not want your children and grandchildren to receive trust reports during your spouse's lifetime. The UTC permits you to designate who receives information about your trust.

Or, you may not want a child to learn the details of the trust until the child reaches a stated age, out of concern that knowledge of the existence of the trust and of the trust's assets might interfere with the child's motivation or initiative. The UTC permits the trust to be designed to keep the child "in the dark" to the extent you desire.

Unless you expressly say otherwise in the trust, virtually everyone who may have a future interest in

the trust is likely to have a right to receive regular reports of the trust's assets.

The UTC permits the use of trust protectors - - an independent person to serve as an overseer of irrevocable trusts and make changes that may be appropriate from time to time. The trust protector can make changes in the trust that you, as the creator of the trust, can't make because if you were to retain the power to make changes, the trust assets would be included in your estate at your death - - precisely the result the irrevocable trust was designed to avoid. The role of a trust protector adds important and advantageous flexibility to irrevocable trusts.

Other provisions of the UTC are similarly helpful in adding flexibility to trust planning in ways that were not previously available. As a result, trust planning, more than ever before, is an invaluable tool to help you achieve your goals for yourself and your loved ones.

CIRCULAR 230

During 2005 the IRS issued new rules that will affect how we and other tax practitioners communicate with our clients. The new rules, issued in Internal Revenue Service Circular 230, apply whenever a practitioner provides written advice on tax issues. The rules grew out of the IRS' attempt to attack abusive tax shelters. Taxpayers engaging in abusive transactions have used the written opinions of tax shelter promoters to escape tax penalties of 20% or more, on top of what they owe in taxes, by claiming that they "reasonably" and in "good faith" relied on the written tax opinion for their belief that the abusive transaction was permissible.

Under Circular 230, clients cannot rely on a tax opinion for protection from penalties unless the practitioner provides a comprehensive opinion that considers and discusses:

- All relevant facts and applicable law;
- The relationship between the facts and the law;
- A conclusion as to the legal consequences of each tax issue; and
- The likelihood that the taxpayer will prevail if the IRS challenges the transaction.

The new rules apply to tax advice for transactions that have a "significant purpose" of tax avoidance, but the rules sweep in many routine, non-abusive transactions. The penalties to practitioners can be severe for providing written advice that does not meet these requirements, including disbarment from practice before the IRS.

As a result, in written communications from us, including e-mails, you can expect to see a notice similar to the one at the end of this letter.

The new rules require that the notice be "prominently disclosed". Please be assured that the existence of the notice does not reflect any decrease in the quality of our services or the level of confidence we have in the advice we provide. However, without the notice, we will be required to provide a comprehensive opinion that meets the standards of Circular 230, which will substantially increase the

cost of the advice we provide. If a comprehensive opinion of tax advice, which meets the requirements of Circular 230, is desired, we are willing to provide it.

LONG TERM CARE PLANNING

In the realm of long term care planning, 2005 has seen substantial changes to the Medicaid system at both the state and federal level. 2006 promises to bring even more changes as Congress and the Maine legislature continue to look to the Medicaid system (administered in Maine under the name "MaineCare") and other programs for budget savings. Federal legislation now pending will make drastic changes to the Medicaid qualification rules for applicants for long term care in a nursing home, including an extension of the "look back" period from 3 to 5 years and a more stringent rule for determining the penalty period for transfers of assets. Maine has changed the way its Department of Health and Human Services calculates penalties for MaineCare eligibility when gifts have been made, has changed the penalty divisor from $3,917 to $5,862, and has changed the estate recovery provisions.

All of these changes will impact long term care planning with MaineCare benefits. If you are currently engaged in a monthly gifting program or are considering applying for benefits, we recommend that you come in to discuss how the recent changes may affect you. Likewise, if you have a loved one who may need long term care we urge you to come in to discuss how these changes may affect their ability to qualify for long term care benefits.

CONGRATULATIONS TO ONE OF OUR OWN

In 2005 David Backer was elected a Fellow of the American College of Trust and Estate Counsel (ACTEC).

Fellows of the College are nominated by other Fellows and are elected by the membership at large. A lawyer cannot apply for membership in the College. Fellows are selected on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching and bar activities.

The purposes of the College are to maintain an association, international in scope, of lawyers skilled and experienced in the preparation of wills and trusts; estate planning; probate procedure and administration of trusts and estates of decedents, minors and incompetents; to improve and reform probate, trust and tax laws, procedures, and professional responsibility; to bring together qualified lawyers whose character and ability will contribute to the achievement of the purposes of the College; and to cooperate with bar associations and other organizations with similar purposes.

David becomes one of a small group of Maine lawyers who have been nominated and elected as ACTEC Fellows.

STATE OF THE ESTATE REVIEW

We have always stressed the importance of reviewing your estate plan on a regular basis in recognition that estate planning is a process, not an event. In light of the continual changes occurring on both the state and federal level, regular reviews remain essential to ensuring that you are able to accomplish your planning goals for yourself and your loved ones. The changes present professional challenges for us as estate planning attorneys as well as for our clients, and we are committed to ensuring that you have the opportunity to keep your estate plan updated.

Absent your request that we schedule a "state of the estate" review with you, we will not be responsible for reviewing or updating your estate plan to reflect changes in the law or for other purposes. Please call us to schedule a "state of the estate" review to ensure that your existing estate planning documents and beneficiary designations are still appropriate, are up to date with recent changes in the law, and meet your planning goals.

- Contact us to schedule an appointment to talk about whether your Will or Revocable Living Trust should be amended to take advantage of the new opportunity created by the Maine legislature in 2005 and to ensure that there is no Maine estate tax due at the death of the first spouse.

- Make sure your Revocable Living Trust, Durable Financial Power of Attorney, and Advance Health Care Directive are updated to be compliant with the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Revocable Living Trusts, Durable Financial Powers of Attorney, and Advance Health Directives routinely name a successor trustee or agent to act on a person's behalf in the event of incapacity. In most estate planning documents, incapacity is established by the written opinion of one or more licensed physicians. To ensure that a physician is able to issue a written opinion to trigger the authority of a successor trustee of a Living Trust, or an agent under a Durable Financial Power of Attorney or Advance Health Care Directive, we advise that the documents contain provisions that address the requirements of HIPAA.

- If you have named your trust as beneficiary of a retirement plan (most commonly an IRA, 401 (k) or 403(b)), ask us to review both the beneficiary designation form and the trust provisions to make sure that they are each appropriate to permit the retirement account benefits to be distributed to the trust without unnecessarily accelerating income tax.

- As a result of the low interest rate and low investment return environment that we have been in for the last few years, many permanent (universal or whole life) insurance policies have not performed as expected. The result is that owners of those policies are finding that they need to pay substantially more than they expected to keep the coverage in force or risk losing the coverage altogether. Due to the reduction in mortality rates in new policies, we have seen clients experience the ability to pay less for the same coverage or increase their coverage for the same cost, all guaranteed. We encourage you to have your policies reviewed, whether you own the policies directly or whether the policies are owned in an irrevocable trust. The most logical source for the review is the agent who sold the policy, if he or she is available and you have confidence in his or her abilities. If you would prefer to have an independent third party review the policy, we will be glad to make a referral to someone qualified to complete the policy review.

- If your personal residence is titled to your Revocable Living Trust and you have not already done so, we encourage you to add yourself, as trustee of your trust (along with any co-trustee if there is one), as an additional insured under your homeowner's policy. There should be no change in the premium for adding the trustee(s) as an additional insured.

Most important, thank you for letting us be your estate planning attorneys. We take seriously the trust that you place in us and we appreciate the opportunity to continue to earn your trust.

Best wishes to you and your loved ones for a New Year filled with good health, prosperity and peace.

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