

Re-emergence of the Vermont Estate Tax

One of the sticking points in the budget negotiations between the Vermont legislature and Governor Douglas has been the legislature's proposed reduction of the state's estate tax exclusion threshold. If passed, the lowered threshold would amount to a higher estate tax on Vermonters who pass more than \$2 million to their children. The Governor disfavors raising taxes, while the legislature seeks to bridge a widening gap between tax revenues and state expenditures.

There are two primary implications of a reduced state estate tax exclusion threshold. The first is obvious, and at the center of the budget debate: higher estate taxes that will be paid by some Vermonters when they die.

The second is equally important, but below the radar: there could be one amount for state estate tax exclusions, and a different amount for federal estate tax exclusions. Although easily accounted for and fixed through careful drafting of your estate plan, this latter issue will catch many families off guard, and when it's likely too late to engage in any last minute edits.

The practical result is as follows. On the federal level, individuals can currently pass \$3.5 million to the next generation without facing a federal estate tax. This amount gets placed in what's often called a Credit Shelter Trust, which is shielded from future federal estate taxes. Any amount over \$3.5 million gets placed in a special trust usually called a Marital Trust, which delays federal estate taxes on this amount until the death of the second spouse. This trust is specifically structured to take advantage of the unlimited marital deduction. This arrangement ensures no taxes are due at the death of the first spouse, so the surviving spouse need not sell off real estate or business interests to raise money for the federal estate tax.

If Vermont reduces its exclusion threshold to \$2 million, then upon the death of the first spouse the surviving spouse will face a dilemma: fund the Credit Shelter Trust at \$3.5 million, or fund it at \$2 million. If funded at \$3.5 million, then Vermont estate taxes will likely be due within nine months of the first spouse's death, because the funds in the Credit Shelter Trust usually do not qualify for the unlimited marital deduction. Or, the surviving spouse could limit the amount in the Credit Shelter Trust to \$2 million and thereby avoid a tax being due within nine months. But this comes at a real cost, because by not filling up the Credit Shelter Trust a much larger federal estate tax could be due later.

This dilemma could be easily avoided by providing the trustee specific authority to make different elections on the first spouse's estate tax return: one for the federal exclusion amount and a separate election for the different state exclusion amount. Doing so avoids the dilemma, because the trustee can both shield the full federal estate tax exclusion amount and avoid the situation where taxes are due within nine months of the first spouse's death.

Many estate plans I've reviewed in Vermont do not include authority for the trustee to make different tax elections for the federal and state exclusions, apparently because the drafting attorney did not consider that Vermont would re-set its exclusion amount at an amount different from the federal level. The resulting lack of authority for the trustee could be very expensive to your family, and entirely unnecessary.

You may be thinking two things: First, that this is all irrelevant if the legislature and Governor come to agreement without reducing the state estate tax exclusion amount. That may be but a one year reprieve. If the state's budget remains problematic, and that will likely be the case, the legislature will probably try again and again until successful. Second, you may think this drafting issue applies only to the very wealthy. Perhaps, but keep in mind that under current federal law, the federal estate tax exclusion shrinks from \$3.5 million to \$1 million in about 18 months. If that occurs, tax savings on the state exclusion level provided by the correct drafting could result in a welcome tax reduction that many estate plans won't be able to take advantage of.

In sum, whether or not the legislature forces a change in the state's exclusion level this year, your estate plan should include flexibility for the trustee to make two tax elections regarding the Marital Trust, one for federal taxes and one for state taxes. In these difficult financial times, everything is subject to change, which is why careful drafting of your estate plan is essential

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