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Dear Connecticut Clients and Friends:

As you probably have seen in the headlines, the new Connecticut law reducing our budget deficit makes an important change in the Connecticut Estate and Gift Tax: the exemption is reduced from \$3.5 Million to \$2 Million. The change is retroactive to January 1, 2011.

As a result of this change, a Connecticut resident who makes a taxable gift in 2011 (or later) which, together with his or her other taxable gifts made after 2004, exceeds \$2 Million, will incur an immediate Connecticut gift tax. Some Connecticut residents who plan on making large taxable gifts in 2011 should take this liability into account.

This change also applies to the estate tax. It will not affect unmarried Connecticut residents with estates of \$2 Million or less, or even married Connecticut residents with estates up to \$2 Million apiece (provided that they have tax-efficient estate plans). For everyone else, however, the \$1.5 Million lost exemption will result in an estate tax increase of up to \$108,000 per estate.

Married persons with estates of more than \$2 Million should consider revising their estate plans to account for the lower Connecticut tax exemption. Typical estate plans for such couples require (or permit) the amount which is exempt from estate tax to be set aside in a trust when the first spouse dies. The trust prevents this amount from being added to the surviving spouse's taxable estate at the time of his or her death. In this manner, each spouse can use his or her \$5 Million federal exemption, permitting the couple to shelter up to \$10 Million from federal estate tax overall.

Now that the Federal and Connecticut exemptions differ by \$3,000,000, however, this very common type of planning encounters a dilemma:

- If the full \$5,000,000 federal tax-free amount is set aside in such a trust, \$3,000,000 will be subject to Connecticut estate tax in the first spouse's estate. The tax will typically be about \$250,000.

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- Alternatively, if only the \$2 Million exempt from Connecticut tax is set aside in such a trust, another \$3,000,000 of assets may be exposed to both federal and Connecticut tax in the second spouse's estate. The additional tax could exceed \$1,250,000.\*

In some circumstances, Connecticut law allows a work-around for this problem: a second, special-purpose trust can be created to hold the \$3 Million difference between the exemptions. This trust will avoid triggering an immediate Connecticut tax in the first estate but will still protect the trust property from federal tax in the second estate. Such trusts must, however, be explicitly called for in the estate plan.

Recently-drawn Davidson, Dawson & Clark documents for married couples often, but not always, include such a trust. It is identified as a "Partially Estate-Tax Sheltered Trust". If your document contains a trust for your spouse but not a "Partially Estate-Tax Sheltered Trust", you should consider an amendment to add this new trust.

That said, while the Connecticut change is nominally permanent, the \$5 Million federal exemption is slated to last only through the end of 2012. After that, Congress will either enact a new tax law, or federal tax law will revert to its 2001 form in which the federal exemption was only \$1 Million. This uncertainty in federal law makes planning difficult for everyone. Nevertheless, our advice for married couples who wish to protect against an inconvenient tax liability is to review this aspect of your documents without delay.

Sincerely,

Davidson, Dawson and Clark LLP

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\* The actual amount could be much less if the new "portable exemption" provisions of federal law are extended. They are slated to expire after 2012.