

Estate Tax Special E-Newsletter

January 31, 2011

TEMPORARY ESTATE TAX RELIEF PRESENTS PLANNING OPPORTUNITIES AND CHALLENGES

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act") into law. In addition to addressing many federal income tax issues, the 2010 Act changed the future of the federal estate, gift and generation-skipping transfer (GST) taxes – **but only for two years**. The 2010 Act is a significant development which may impact the estate plans of many individuals.

There are several important facts to know about the estate, gift and GST tax provisions of the 2010 Act, beginning with a brief background.

Background

On January 1, 2010, the estate tax and GST tax were repealed. Repeal was put in place by a law passed in 2001. However, repeal was only scheduled to last for one year. The estate and GST taxes were scheduled to return on January 1, 2011, and the estate tax exclusion amount (*i.e.*, the amount an individual can leave at death to anyone free of federal estate tax) was scheduled to be \$1,000,000. The GST exemption was scheduled to be approximately \$1,360,000. These figures represented a significant drop from the \$3,500,000 estate tax exclusion and GST exemption amounts that were in effect in 2009.

The one year of repeal and the scheduled drop in the exemption amounts in 2011 created significant estate planning challenges for many individuals. Furthermore, although repeal of the estate tax and GST tax for the year 2010 was potentially beneficial for some individuals, there were numerous ambiguities in the law that posed problems for certain gifting techniques and for the administration of estates.

The 2010 Act: A Temporary Solution

The 2010 Act provides a temporary solution for the estate and GST tax problems caused under the prior law. The 2010 Act makes changes retroactive to January 1, 2010. The Act is in effect through December 31, 2012, and then it expires.

Estate Tax: For 2010 and 2011, the estate tax exclusion amount is \$5,000,000, with a maximum rate of 35%.¹ In 2012, the \$5,000,000 estate tax exclusion amount will be adjusted for inflation, but there will be no change to the rate. In 2013 and beyond, the estate tax laws will revert back to the laws in place before 2001 (*i.e.*, an estate tax exclusion amount of \$1,000,000, with a maximum rate of 55%).

Gift Tax: For gifts made in 2011 and 2012, the gift tax is reunified with the estate tax, so that the gift tax exclusion amount will be \$5,000,000 in 2011 (and indexed for inflation in 2012), with a maximum gift

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tax rate of 35%. In 2013 and beyond, the gift tax laws also revert back to the laws in place before 2001, leaving a gift tax exclusion amount of \$1,000,000 and a maximum rate of 55%.

GST Tax: The GST tax remains unified with the estate tax, so that the GST tax exemption is \$5,000,000 in 2010 and 2011 (and indexed for inflation in 2012), with a tax rate of 35%. Similar to the estate and gift taxes, the GST tax laws also revert back in 2013, leaving the GST tax exemption amount at approximately \$1,360,000 (\$1,000,000 indexed for inflation) and a rate of 55%.

Year	Estate Tax Exclusion	Gift Tax Exclusion	GST Exemption	Highest Rate
2010 ¹	\$5,000,000	\$1,000,000	\$5,000,000	35%
2011	\$5,000,000	\$5,000,000	\$5,000,000	35%
2012	\$5,000,000 ²	\$5,000,000 ²	\$5,000,000 ²	35%
2013	\$1,000,000	\$1,000,000	\$1,360,000 ²	55%

Portability of Unused Estate Tax Exclusion Between Spouses

The 2010 Act also incorporates the concept of portability of the unused estate tax exclusion amount between spouses. Portability has never been part of the estate tax laws before. For the years 2011 and 2012, any estate tax exclusion amount that remains unused at a spouse's death may be available for use by the surviving spouse, as an addition to the surviving spouse's estate tax exclusion amount. There is no portability for decedents who died in 2010.

For example, assume Husband dies in 2011 having made no taxable transfers during life and with a \$3,000,000 taxable estate. An election can be made on Husband's timely filed federal estate tax return ("Form 706") to permit Wife to use Husband's unused estate tax exclusion amount. Then, assuming that Wife has made no taxable transfers during her life, Wife's estate tax exclusion amount in 2011 will be \$7,000,000 (Wife's \$5,000,000 basic estate tax exclusion amount, plus \$2,000,000 of Husband's unused estate tax exclusion amount).

There is no portability of a deceased spouse's unused GST tax exemption; portability is limited only to unused estate tax exclusion.

The portability of the deceased spouse's unused estate tax exclusion amount is only available if an election is made on a timely filed Form 706 on the death of the first spouse to die, regardless of whether the estate of the deceased spouse is otherwise required to file a Form 706.

The Future of the Estate, Gift and GST Taxes

Prior to the passage of the 2010 Act, Congress considered numerous proposals to either repeal the estate tax permanently or to provide for long-term revised estate, gift and GST tax laws. In light of the short term solution provided by the 2010 Act, it is likely that these issues will once again be raised as we move closer to the year 2013. It is impossible to predict with any certainty whether Congress will change the estate, gift and GST tax laws prior to 2013 and, if it does, exactly what changes will be passed. There are at least three possible outcomes:

1. No Action by Congress. In light of Congress' inability to reach consensus on the estate, gift and GST taxes in the past, it is possible that the current laws will be allowed to sunset beginning in 2013. As described above, this would mean that the estate and gift tax exclusion amounts would revert to \$1,000,000, and the GST exemption would be approximately \$1,360,000. There will be no portability of estate tax exemption.

2. **Repeal.** Some legislators would like to see permanent repeal of the estate, gift and GST taxes. In order to replace this lost revenue, permanent repeal could mean that the unlimited step-up in basis would be restricted (*i.e.*, that the modified carryover basis rules that are optional for the year 2010 would be reinstated).

3. **Making the Temporary Provisions of the 2010 Act Permanent.** Congress could choose to extend the provisions of the 2010 Act for some longer period of time, or choose to make those provisions permanent for 2013 and beyond.

Planning Tips

You should continue to be proactive about your estate planning. The 2010 Act grants a window for certain planning opportunities, and that window may close in 2013. Also, the \$5,000,000 exemption amounts and portability of estate tax exclusion will be highly beneficial for estates of decedents dying in 2011 or 2012, but for individuals planning for the future, the scheduled sunset of the 2010 Act in two years presents several challenges. The following are some planning suggestions.

1. **Review Your Estate Plan.** You should review your estate plan to make sure it has the flexibility to meet with your wishes under current (and any future) estate, gift and GST tax laws. The following non-exclusive list of issues should be considered:

- How will your plan work now that the estate tax exclusion amount is \$5,000,000? Some marital deduction formula plans could effectively disinherit a surviving spouse.
- Will your planning still meet with your wishes if the estate tax exclusion amount drops back to \$1,000,000 in 2013?
- Should you consider gifting options to reduce the value of your estate?
- Large gifts to GST trusts may be especially advantageous.

2. **Do Not Rely on Portability.** Portability will be very useful in many situations where one spouse dies without fully utilizing his or her estate tax exclusion amount. However, relying on portability is not a substitute for a thoughtful estate plan. Historically, a traditional means of using the first spouse's estate tax exclusion amount is to have assets up to the exclusion amount pass to a family (bypass) trust at the first spouse's death. Some of the shortcomings of portability (as compared with funding a family trust) are as follows:

- **Repeal of Portability.** If the 2010 Act sunsets at the end of 2012, portability will be lost. Even if the first spouse dies in 2011 or 2012, it appears that the surviving spouse will only be able to use the first spouse's unused exclusion amount if portability is still the law at the surviving spouse's death.
- **Appreciation of Assets.** When a family trust is funded, the assets of the trust are not subject to estate tax at the surviving spouse's death. The assets in the family trust may appreciate significantly between the date of the first spouse's death and the date of the surviving spouse's death. Therefore, the amount of assets excluded from the survivor's estate may be much greater than the exclusion amount that was available when the first spouse died. This benefit is not available with portability. Portability allows the surviving spouse to utilize only the unused exclusion amount of the first spouse, without any adjustments for inflation or otherwise.

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- GST Planning. The GST exemption can be used to place assets in trust for several generations, without incurring any estate tax after the original transfer. The current portability rules do not apply to a deceased spouse's unused GST tax exemption (*i.e.*, the surviving spouse cannot use the deceased spouse's unused GST exemption). By creating a family trust at the first spouse's death, that spouse's GST exemption can be utilized.
- Benefits of a Trust. There may be non-tax reasons to leave assets in trust for a surviving spouse, rather than outright. For example, trusts can provide some protection for the trust assets from the surviving spouse's creditors and rights of a subsequent spouse in the event of remarriage.

3. ***File an Estate Tax Return.*** In the case of every married individual dying in 2011 and 2012, consideration should be given to filing a federal estate tax return, even if a return is not required. In order for any of the decedent's unused estate tax exclusion amount to be available to the surviving spouse (*i.e.*, to be portable) a federal estate tax return must be timely filed for the estate of the first spouse to die.

4. ***Make Annual Exclusion Gifts.*** Making gifts under the gift tax annual exclusion amount (currently \$13,000) is still a good planning technique for many individuals, especially those who would have taxable estates if the current laws sunset in 2013. If you forgo annual exclusion gifting in 2011 and 2012, you miss the opportunity to make gifts in these years free of gift tax consequences.

5. ***Make Larger Gifts.*** Making gifts above the annual exclusion amount to utilize the expanded lifetime gift tax exclusion amount (now \$5,000,000) may also be a good planning strategy. Using gift tax exclusion amount reduces the estate tax exclusion available at death, but can still be useful for several reasons, such as:

- Gifting an asset removes subsequent appreciation of that asset from your estate.
- Certain gifting techniques allow leveraging of the gifted amounts.
- If the gift and estate tax exclusion amounts drop to \$1,000,000 in 2013, there is only a two year window of opportunity to use the full \$5,000,000 of gift tax exclusion.³

Conclusion

The passage of the 2010 Act is a significant event, but it is only a temporary fix whose application is limited to 2011 and 2012. You should understand how the recent tax changes impact your planning and make any necessary steps to take advantage of all possible planning opportunities.

¹ Estates of decedents dying in 2010 can elect out of the estate tax, in which case modified carryover basis rules apply, which limit the amount of step-up in basis available for the decedent's assets. For estates subject to estate tax, step-up in basis is unlimited.

² Indexed for inflation.

³ Such gifts may have estate tax repercussions after sunset of the 2010 Act at the end of 2012 because of the way prior gifts are taken into account in calculating estate tax due.

The information in this newsletter is intended to give a general overview. You should not rely on it as legal advice. Please let us know if you would like us to review your estate planning and advise you as to your specific situation.