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Re: Transfer Tax Changes for 2011

Dear Clients and Friends:

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act") into law. The Act reinstated the Bush-era income tax cuts for two additional years, through 2012, temporarily reduced the payroll tax, and significantly liberalized the estate and gift tax laws.

The Act gives some certainty about future taxes, but only for two years. It does postpone, through 2012, the scheduled reinstatement of the more onerous gift, estate and generation-skipping transfer ("GST") tax rules which were in effect prior to 2001, but it gives no guidance as to what the rules might be thereafter.

Much has been written about the income tax changes. This letter will focus exclusively on the federal estate, gift and GST tax (collectively, "transfer tax") changes, with special emphasis on their effect on existing Wills and estate plans.

## THE NEW ACT

### Rates and Exemptions

Absent legislative action, transfer taxes would have reverted to the pre-2001 rates and exemptions on January 1, 2011: a maximum rate of 55% and a \$1 million exemption. Under the Act, however:

- The maximum federal estate, gift and GST tax rates are each set at 35% for 2011 and 2012.
- The estate, gift and GST tax exemptions are all significantly increased, to \$5 million for 2011 and 2012, and will be indexed for inflation in 2012.
- The familiar \$13,000 gift tax annual exclusion remains in effect.
- The Act also reinstates the unlimited "step-up" in basis for assets inherited from a decedent (replacing the "modified carryover basis" regime described below that had been

in effect for 2010). The step-up will, in effect, forgive any capital gains tax on gains that were accrued but not realized prior to the decedent's death.

- The GST tax was retroactively reinstated for 2010, but with a tax rate of 0%. Accordingly, no GST tax will be due on certain GST transfers made in 2010. ("GST transfers" are gifts, outright or in trust, to grandchildren or lower generations.)
- A special election is available to the estates of decedents who died in 2010. They can choose either (i) modified carryover basis with no estate tax, or (ii) the new 2011 estate tax rules with an unlimited basis step up. See below.
- Absent further legislation, the new rules "sunset" on December 31, 2012, and the pre-2001 rates and exemptions described above return on January 1, 2013.

To summarize:

	2010	2011	2012	2013 &c. (if not changed)
Estate Tax Exemption	\$5,000,000 (or Carryover Basis)	\$5,000,000	\$5,000,000, Indexed	\$1,000,000
Gift Tax Exemption	\$1,000,000	\$5,000,000	\$5,000,000, Indexed	\$1,000,000
GST Exemption	\$5,000,000	\$5,000,000	\$5,000,000, Indexed	\$1,400,000*
Estate Tax Rate	35% (or Carryover Basis)	35%	35%	37% - 55%
Gift Tax Rate	35%	35%	35%	37% - 55%
GST Tax Rate	0%	35%	35%	55%

\* Estimated; the GST Exemption is already indexed for inflation..

## Repeal of Carryover Basis; Election for 2010

The Act generally repeals the "modified carryover basis" rules for determining the income tax cost of property acquired from a decedent. Under these rules, the executor of an estate was required to determine, and with limited modifications the beneficiary of the property was required to use, for capital gains tax purposes, the decedent's historical tax cost for each asset of the estate. The rules were complex and difficult to apply.

Under the Act, the executor of a 2010 estate may either:

- allow the 2011 federal estate tax to apply, with an exclusion of \$5,000,000, a 35% tax rate, and a full step-up in basis for all assets inherited from the decedent; or
- opt out of federal estate tax and have the modified carryover basis rules apply.

The former is the default, i.e., automatic. The latter has to be elected.

As a general rule, estates below the \$5 million level would accept the default provision in order to get a step-up in basis. These estates would pay no federal estate tax anyway, because of the higher exemption.

The Act extended the due date for filing estate and generation-skipping transfer tax returns for 2010 estates and gifts, and for making disclaimers of 2010 bequests, to nine months after the date of enactment (i.e., to September 19, 2011, since September 17 falls on a Saturday). It is not yet certain when the basis allocation return will be due for estates that opt for the modified carryover basis regime.

## **Portability Between Spouses Of Unused Estate Tax Exemption**

The Act creates a brand new “portability” rule. Beginning in 2011, a decedent’s unused estate tax exemption (but not GST tax exemption) can be used by his or her surviving spouse, either for gifts during life or for estate tax reduction at death. The unused exemption can be “inherited” (to use shorthand) by the surviving spouse only if an estate tax return containing an election to do so is timely filed for the estate of the first spouse to die.

In simple cases portability could lessen the cost and complexity of federal estate tax planning by reducing the need to equalize assets between spouses and create so-called “Estate Tax-Sheltered,” “credit-shelter” or “bypass” trusts. As an added benefit, assets covered by the inherited exemption should get a second step-up in basis at the surviving spouse’s death.

Nevertheless, the portability rule comes with some complexities and limitations of its own:

- To pass unused exemption to the surviving spouse, a federal estate tax return must be filed for the first spouse to die (even if not otherwise required) and retained as proof of the transfer.
- The inherited exemption amount does not grow with inflation. By contrast, a bypass trust can grow without limit, thus sheltering all of its appreciation and any accumulated income from estate tax.
- The inherited exemption is not currently honored for state estate tax purposes in states with their own estate tax systems, including New York and Connecticut.
- The inherited exemption is also not honored for GST tax purposes.
- The Act provides that only the exemption of the most recently deceased spouse can be inherited. A widow or widower who remarries may therefore need to take special steps to avoid loss of his or her inherited exemption. To illustrate: if a deceased husband’s exemption is completely unused, his surviving wife would have a combined exemption of \$10 million for gifts and estate transfers (but only \$5 million for GST). If she remarries and her second husband predeceases her leaving only \$1 million of unused exemption, her exemption would be reduced to only \$6 million. By contrast, the tax benefit of a bypass trust is not affected by remarriage.
- The effect of an inherited exemption after 2012 is unknown. Absent new legislation, it could cease to exist.

## PLANNING

This legislative compromise stays in place for only two years. As a result, the environment for long-term planning remains challenging. However, even though the new rules are temporary, they do suggest that some estate plans should be re-evaluated promptly, to achieve maximum tax savings and ensure that the new law does not distort dispositive provisions or create ambiguities that could lead to unintended results.

### **React to the Change in the Estate Tax and GST Exemption.**

*All Wills and trusts that set the amounts passing to family members or trusts by means of a tax-related formula should be reviewed.* Formulae based on the exemption from the federal estate or generation-skipping transfer tax will now have different results. The exemption amount will almost certainly be higher than originally contemplated, so the division of assets among family members may be skewed, and in some cases, a significant amount of state estate tax may be triggered. Such formula mechanisms are especially common for married couples and for clients with generation-skipping plans. If you are uncertain whether your plan includes such a formula, you should ask your DD&C attorney to review it.

If you decide that a bypass trust would be more advantageous than reliance on the temporary portable exemption rule, it may be necessary to rebalance your assets between spouses so that, whichever spouse dies first, none of the larger exemption would be wasted. See below.

### **Beware of Relying on Portability of Exemptions.**

The “portability” rule can simplify estate plans and estate administration, but it has significant drawbacks, as outlined above.

The traditional bypass trust, while requiring trust administration, can offer the usual non-tax benefits of a trust, such as creditor protection, control over distributions, and determination of the ultimate beneficiaries. It will also shelter the trust assets from estate tax regardless of how fast they grow (in fact, a common strategy is to hold the family’s high-growth assets in such a trust and accumulate the income). A bypass trust avoids the possible loss of inherited exemption by a surviving spouse who remarries, and it can preserve the unused GST exemption of the first spouse to die.

As a result, complete reliance on “portability” may not be suitable for some estates, especially those with generation-skipping planning. It is also risky to rely exclusively on this rule given the prospect of its “sunset” after 2012. It is possible, however, to draw a plan with an optional “bypass” trust, so that either a trust or a portable exemption, or a combination of both, could be elected by the executor and surviving spouse when the first spouse dies.

Thus, if you currently have a plan with a bypass trust (as is common for married couples), you may not need to change your Will at this time. You should consult with your

DD&C attorney to determine to what extent, if any, your assets need rebalancing, and whether to make the bypass trust optional or of limited size.

### **Use the Potentially Temporary \$5,000,000 Gift Tax Exemption.**

Because of the increased exemption, large gifts made in 2011 or 2012 may trigger no immediate federal transfer tax at all. Even individuals who had previously exhausted their \$1,000,000 gift tax exemption will have the opportunity to give another \$4,000,000 (or \$8,000,000 in the case of a married couple) without immediate tax.

They can even make increased gifts to grandchildren or more remote descendants (or to trusts for their benefit) without incurring a GST tax, due to the larger GST exemption. Individuals who previously exhausted their \$3,500,000 GST exemption available in 2009 will now have an additional \$1,500,000 (or \$3,000,000 per couple) available for multi-generational estate planning.

### **Make Good Use of Your GST Exemption.**

The GST tax rate for 2010 was retroactively set at 0%, so there may be no need to use any of your GST exemption on generation-skipping gifts that you made last year. To make certain that your exemption is not applied to such gifts automatically and thereby wasted, a special election on your 2010 federal gift tax return may be required.

### **Plan Larger Gifts for Best Effect.**

The larger the gift, the more important it is to make use of your exemption efficiently. Both the timing and the legal structure of your gift play a role.

#### **A. Gift Timing**

Any time asset values are depressed and tax exemptions are high is a good time for tax-efficient gifts. For example, clients who want to transfer valuable homes (perhaps through a Qualified Personal Residence Trust, or "QPRT"), but were deterred by the immediate tax liability last year, may now be able to make these gifts tax-free.

It is not possible to predict whether the larger gift tax exemption will be extended beyond 2012, increased, reduced, or even repealed without warning. It is instructive that one bill introduced last year would have re-enacted the federal estate tax early, with no prior notice.

Many individuals will therefore want to use their \$4,000,000 of additional gift tax exemption well before the end of 2012. In fact, it may be best to make these gifts immediately, to avoid unexpected changes in the law and to remove further growth and income from the donor's estate.

At a minimum, you should consider whether you would be comfortable granting a Power of Attorney that authorizes large gifts on your behalf. For various reasons, many Powers of Attorney authorize only small gifts.

#### B. Gift Structure

Selecting the optimal wealth-transfer techniques and choosing the right assets to use are important. Among the best current techniques are intra-family low-interest loans, sales to a grantor trust, grantor retained annuity trusts, and multi-generational trust planning. The larger exemptions should facilitate gifts of valuable homes in QPRTs, or even of family business interests. All these techniques have been covered in previous DD&C newsletters. Your DD&C attorney can supply copies if you have an interest.

### CONCLUSION

The new law provides more generous exemptions, lower rates, and legal certainty, but only for two years. Within that brief window, some opportunities exist that may never return. Please, however, discuss these changes with your attorney before you take action. We are ready to help you take advantage of these changes as they affect your individual situation.

Sincerely

Davidson, Dawson & Clark LLP

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