The Wealth Counselor

A monthly newsletter for wealth planning professionals

Highlights of the New Estate, Gift and Generation-Skipping Tax Legislation

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At Price & Farrington, PLLC we work closely with our professional colleagues to help our clients plan, protect and pass their legacies to their loved ones through caring and confidential counseling.

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This legislation had some surprises for those who had been following the process. In addition to extending unemployment benefits, current income tax rates (the Bush tax cuts) were extended for ***all*** taxpayers for two years, and the estate tax was also extended for two years - with a $5 million exemption and 35% tax rate! (Wasn't it just a few weeks ago that, with this same Congress, come January 1, 2011, we were expecting to go back to a $1 million exemption and a 55% top tax rate?)

In this edition of ***The Wealth Counselor***, we will take a first glance at the changes in the federal estate, gift and generation-skipping taxes as included in this new law. Future issues will address planning options and concerns in more detail.

Estate, Gift and Generation-Skipping Transfer (GST) Tax Exemptions and Rates

For the next two years, 2011 and 2012, the gift, estate and GST tax exemptions are unified again, with the exemption set at $5 million and the tax rate at 35%. The $5 million exclusion is indexed for inflation beginning in 2012.

It's important to remember that these changes are effective only for the next two years. On January 1, 2013, if Congress does not act again, the gift, estate and GST exemptions will be $1 million (adjusted for inflation) and the top tax rate will be 55%.

Optional Retroactive Planning for 2010 Decedents

Under this new law, the federal estate tax has been reinstated for 2010, with the $5 exemption and 35% tax rate and full basis adjustment to date of death value.

However, executors for those who died in 2010 have the option of electing no estate tax with a modified carryover basis (unlimited step-down for loss assets and a limited step-up of $1.3 million plus $3 million for assets passing to a spouse). Executors have an additional nine months after the enactment date to decide, file an estate tax return, pay taxes and make disclaimers.

Planning Tip: Electing the modified basis option would generally be advantageous for 2010 decedents with estates that would not be covered by the $5 million exemption. However, each case should be evaluated and determined individually, considering the amount of estate tax payable now vs. income tax that would be due on the gain when assets are sold in the future; expected sales dates; possible future capital gains and ordinary income tax rates; the ability to increase basis up to fair market value as of the date of death on assets that will be sold in the near future, etc.

Planning Tip: The extended time for filings provides additional planning flexibility given the extent of the change in the estate tax law. However, one concern is that beneficiaries may have already accepted benefits, not realizing that the disclaimer period would be extended. Also, disclaimers made during the extended time period, while following federal law, may not satisfy current state law requirements; state statutes may also need to be modified to accommodate the extended deadline.

Gifts and Generation-Skipping Transfers

For 2010, the gift tax exemption remained at $1 million with a 35% tax rate, but the GST exemption was reinstated at $5 million with a 0% tax rate for 2010 only. For 2011 and 2012, the gift and GST exemption is $5 million with a top rate of 35%.

Planning Tip: Remember, if Congress does not act again before the end of 2012, on January 1, 2013, the estate and gift exemptions will return to $1 million and the GST exemption will decrease to $1 million (adjusted for inflation), all with a top tax rate of 55%. With that possibility in mind, those with estates that could be taxable in 2013 should consider using their $5 million gift and GST tax exemptions in 2011 and 2012.

Portability of Estate Tax Exemptions Between Spouses

For those dying in 2011 or 2012, the executor of the estate may transfer any unused estate tax exemption to a surviving spouse. Because the election is made by filing a timely estate tax return, it may be advantageous to file an estate tax return for smaller estates on the death of the first spouse to die in order to transfer the unused exemption to the surviving spouse.

Only the most recent deceased spouse's unused exemption may be used by the surviving spouse, which could impact the decision of a surviving spouse to remarry because, if the new spouse should die first, the unused exemption of the second deceased spouse, if any, would replace that of the first deceased spouse.

Portability vs. the Credit Shelter Trust

Despite the apparent simplicity of leaving everything to the surviving spouse and relying on portability, there are strong reasons to continue to use credit shelter trust planning. These include:

- The credit shelter trust provides asset protection for the surviving spouse;
- The deceased spouse's unused exclusion amount is not indexed for inflation;
- The deceased spouse's unused exemption will be lost if the surviving spouse remarries and survives his/her next spouse;
- Appreciation of assets left to the surviving spouse is included in the surviving spouse's gross estate whereas appreciation of assets in the credit shelter trust is not;
- There is no portability of the deceased spouse's unused GST exemption; and
- The credit shelter trust allows the deceased spouse to make sure that the assets in that trust are managed and distributed according to his/her wishes and not those of the surviving spouse.

Planning Opportunities Ahead

Being able to make transfers of up to $5 million ($10 million per couple) without having to pay gift taxes allows for planning opportunities that, combined with leveraging strategies, can transfer huge amounts of wealth. These include:

Simple Gifts
Being able to give up to $5 million ($10 million per couple) in a lifetime will allow many to make all of the lifetime transfers they want without any concerns about

gift taxes.

Leveraged Transfers to Trusts
Making transfers to income-tax grantor trusts (under which the trust income is attributed to the donor) can allow substantial additional trust growth and drain away the donor's taxable estate. Because the trust does not pay the tax on trust income, the trust assets will grow faster. Plus, the donor, by continuing to pay the income tax, further reduces his or her estate.

Gifts to trusts can substantially increase wealth transfer opportunities by making the trust able to buy assets from the donor. For example, a gift of $10 million by a married grantor to an irrevocable trust will allow a sale of an additional $100 million of assets to the trust financed by an intra-family loan at current historically low interest rates.

If the trust in this example is an income-tax grantor trust, further depletion of the grantor's taxable estate will result from the grantor paying income taxes on the income generated by the entire $110 million in the trust without having to recognize as income any of the interest paid from the trust to the grantor.

If the transferred assets can be discounted for lack of control and/or marketability, the asset value that can be transferred using the lifetime million dollar gift tax exemption is further increased.

Gift Splitting
If one spouse has most of the marital wealth, the couple can make the split gift election and take advantage of both spouses' gift exemptions of $5 million.

Life Insurance Transfers
A very large amount of life insurance coverage can be purchased with gift exemptions of $5 million and $10 million. If structured properly, the insurance proceeds can pass free of probate, income and estate taxes to younger generations.

Other Items of Interest

While this newsletter has focused on the gift, estate and GST tax provisions of the new temporary tax act, we should at least mention some of the other provisions of the new law. These include:

- Individual tax rates will remain at 2010 levels (10, 15, 28, 33 and 35%) for two more years. If no action had been taken, all of those tax rates would have increased.
- Tax on long-term capital gains and qualified dividends remains at 15% for two more years. If no action had been taken, capital gains would have

been taxed at 20% and dividends would have been taxed as ordinary income.

- Taxpayers will not see their itemized deductions or personal exemptions limited due to income levels in 2011 or 2012.
- The deduction for direct charitable donations from an IRA for those 70 1/2 or older was extended for two more years and such contributions made before January 31, 2011, can be attributed to 2010.
- The AMT (alternative minimum tax) exemption for a married couple was increased from $45,000 to $72,450.
- Investments in new business equipment from September 8, 2010, through the end of 2011 qualify for a deduction of 100% of their cost in the year of acquisition. Acquisitions in 2012 qualify for a deduction of 50% of the cost. There are, of course, restrictions that apply.

Conclusion

While the new temporary tax law provides some challenges, there are tremendous planning opportunities for your clients to transfer incredible amounts of wealth over the next two years. At the same time, for clients who have less than $5 million estates ($10 million if married), the focus can return to planning that concentrates on family goals and objectives without, at least for the next two years, having to jump through hoops to avoid federal estate taxes. (Of course, state inheritance taxes and income taxes must still be considered.) With so much to offer them, now is the perfect time for the planning team to encourage clients to move forward with estate, retirement and disability planning.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

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