Client Alert.

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Estate, Gift and Generation-Skipping Transfer Tax Changes And Their Effect On Your Estate Plan

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (H.R. 4853, "the Act"). The Act affected a wide range of taxes, among them the estate tax, the gift tax, and the generation-skipping transfer ("GST") tax.

The passage of the Act brought some welcome certainty to us and to our clients with respect to their estate planning. However, the Act's beneficial changes are like Cinderella at the ball: they will expire at the stroke of midnight on December 31, 2012, if not extended by Congress beyond 2012.

ESTATE TAX CHANGES

- After its one-year temporary repeal in 2010, the estate tax is now back in place, with a 35% maximum rate in 2011 and 2012. (By comparison, the maximum rate was 45% in 2009 and had been scheduled to return to 55% this year.)
- The Act increased the *applicable exclusion amount* — often referred to as each person's "estate tax exemption" — to $5 million, much higher than it has ever been.[1] This will exempt an estimated 99.8% of US decedents' estates from federal estate tax.[2] (By comparison, the exemption amount was $3.5 million in 2009 and had been scheduled to return to $1 million this year.)
- With the return of the estate tax comes a return of the step-up (or step-down) in income tax basis for all of a decedent's capital assets.
- The Act also introduced a new "portability" feature, which allows a surviving spouse to take advantage of the unused estate tax exemption of a predeceased spouse. It will require the filing of an estate tax return in order to capture the amount of the first spouse's unused exemption. (A return might not otherwise be required if the predeceased spouse's gross estate is under $5 million in value.) This feature will expire at the end of 2012.

[1] Special rules and/or lower exemptions will continue to apply to nonresident aliens, and to property that is given to a spouse who is not a US citizen, and to domestic partners.
[2] Based on the analysis of the nonpartisan Tax Policy Center.

GIFT TAX CHANGES

- Last year's one-year drop in the maximum gift tax rate — from 45% to 35% — prompted many clients to consider making gifts in excess of their $1 million lifetime gift tax exemption, particularly in view of the scheduled return of the 55% maximum estate and gift tax rate. The Act extended the 35% rate for gifts made during 2011 and 2012. Moreover, the Act increased the gift tax exemption amount from $1 million to $5 million. Consequently, many individuals who were planning large gifts last year postponed them to take advantage of this significant increase in the exemption amount.
- The Act "unified" the estate and gift tax exemptions for two years, meaning that every US citizen or resident taxpayer now has a total exemption of $5 million that can be used on cumulative lifetime *and* testamentary gifts before the gift tax or estate tax will apply to their transfers. In other words, to the extent that the full exemption is used for lifetime gifts, it will not be available for gifts at death.

GENERATION-SKIPPING TRANSFER TAX CHANGES

The GST tax existed from 1986 through 2009 as an *additional* transfer tax, at a flat rate equal to the highest estate and gift tax rate. The tax was imposed on transfers (including transfers in trust) in excess of a GST exemption amount[3] to (or for the benefit of) persons two or more generations below the transferor. The GST tax

[3] The GST exemption amount generally tracked the estate tax exemption amount.

was repealed last year, but was scheduled to be reinstated in 2011 at a 55% rate for aggregate GST transfers in excess of $1.36 million.

- The Act increased the GST exemption amount to $5 million and lowered the GST tax rate to 35% for 2011 and 2012. This makes large gifts to or in trust for the benefit of grandchildren more appealing (from a tax perspective) this year and next year.
- Unlike the estate and gift tax exemption amounts, the GST exemption amount is not portable between spouses.
- The Act also did something unusual and unexpected, by imposing the GST tax retroactively for 2010 with a $5 million exemption, but with an applicable rate of “zero” for generation-skipping transfers. Many individuals took advantage of this in the last two weeks of 2010 by making significant gifts to or in trust for the benefit of their descendants.

ADDITIONAL THOUGHTS

- The estate, gift, and GST tax exemption amounts are indexed for inflation starting in 2012; however this may be of limited utility if the increased exemption amounts are allowed to sunset on December 31, 2012.
- Despite the increase in the estate, gift and GST tax exemption amount to $5 million per person, and $10 million per married couple, it will continue to be prudent from a tax perspective for married couples to consider establishing bypass or credit-shelter trusts in their estate plans. These trusts will capture the exemption amount of the first spouse to die, as well as any net income and appreciation, and shield the trust property from estate taxation on the death of the surviving spouse, which could occur if portability disappears or if the exemption amounts are reduced by future Congressional action (or inaction).

WHAT DO ALL THESE CHANGES MEAN FOR YOU?

A year ago we recommended that clients check their estate plans, or have them reviewed by an attorney, to make sure that their plans worked in last year’s world of estate tax and GST tax repeal and the modified carryover basis regime that applied for inherited assets. Our advice remains the same, but for a more positive reason.

First, you will want to make sure that if you are married and your estate plan uses a formula that is keyed to the federal estate tax exempt amount (as many plans do), that you are comfortable with the increased amount that will be received by the beneficiaries of the exempt portion: this could be up to $5 million, or even up to $10 million for decedents who “inherited” a predeceased spouse’s full estate tax exemption amount. Keep in mind that the more that goes to these beneficiaries, the less that will pass to or in trust for the exclusive benefit of a surviving spouse.

Second, you may want to consider taking advantage of the lower maximum gift tax rate and the increased exemption amount. Given continued depressed asset values, the increased gift tax exemption amount, the continued low 35% maximum gift tax rate, relatively low interest rates, and the fact that it remains possible to leverage the value of gifts of fractional or minority interests in property or entities through discounts (supported by appropriate appraisals), 2011 and 2012 present the opportunity to make significant gifts in a very tax-efficient way. There are many creative types of gift scenarios for those who are interested and in a position to take advantage of this opportunity.

If you have questions about your specific estate plan, or want to ensure that your plan would still operate as intended under the new laws, please call us for a review and analysis. Also, call us if you have questions about how the laws would apply for estates of decedents who passed away in 2010, since the Act presents executors of these estates with some complicated choices.

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