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2010 Tax Act

The recent election season and its aftermath were filled with discussions of the so-called "Bush tax cuts." A significant part of the debate involved the federal estate and generation skipping transfer tax (or "GST tax" for short). Along with the gift tax, the estate and GST taxes are the three taxes that federal law imposes on the transfer of wealth.

The Bush tax cuts were contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). Under EGTRRA, the federal estate and GST taxes were repealed for decedents dying and GST transfers made in 2010. In order to comply with arcane Congressional procedural rules, the repeal of the estate and GST taxes by EGTRRA was effective for only one year—2010. A failure by Congress to enact legislation by the end of 2010 would have meant that the estate, gift and GST taxes would have returned to their pre-June 7, 2001 provisions (June 7, 2001 was the effective date of EGTRRA).

The uncertainty about what Congress might do about transfer taxes—and when—concerned many clients who understandably wanted to have clear rules about how federal law would affect their estate planning.

In the interest of simplicity, we will not discuss the pre-June 7, 2001 transfer tax provisions. Why? On December 17, 2010, President Obama signed the "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" (here, the "2010 Tax Act"). The 2010 Tax Act covers the regular income tax and alternative minimum tax in addition to transfer taxes. This LEGALcurrents will focus on the most important transfer tax provisions of the 2010 Tax Act as they relate to planning in 2011 and beyond. Following this discussion, we will comment on the effect of provisions on clients' planning.

Unfortunately, since clients' situations may vary widely, our discussion must be generic. We suggest that you review your planning documents. We would be pleased to send you copies if they are not readily available.

Overview

- The legislation is temporary. The 2010 Tax Act expires by its terms on December 31, 2012. If Congress does not act before then (or make any subsequent legislation retroactive), the transfer tax provisions in effect as of June 7, 2001 will again apply.
- The estate and GST tax exemptions are increased to $5,000,000 as of January 1, 2010. The gift tax exemption is increased to $5,000,000 as of January 1, 2011. The $5,000,000 exemption is to be indexed for inflation beginning in 2012.
- The estate and gift tax rate is a flat 35%. The GST tax rate will not exceed 35% but may be lower depending on the allocation of a transferor's GST exemption.
- The amount of federal estate tax exemption that a deceased spouse did not use (for example, he or she left all property to the surviving spouse), is effectively inherited by the surviving spouse. Using some estate tax jargon, the exemption is "portable" between spouses.

To illustrate: assume that the first spouse to die had a $5,000,000 estate and left $1,000,000 to children and $4,000,000 to the surviving spouse. Only $1,000,000 of the deceased spouse's exemption would be used because the disposition to the spouse qualifies for the marital deduction. With portability, the survivor would "inherit" the unused balance of the exemption, or $4,000,000. Thus, at the death of the surviving spouse, his or her estate would have $9,000,000 of exemption available.

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- The change in the basis of most assets to their value for federal estate tax purposes—the so-called "step-up in basis"—has been restored. The change in basis eliminates tax on capital gains accruing before a decedent's death.

Some Comments About the 2010 Tax Act

Based on the debate about the 2010 Tax Act, both Democrats and Republicans agreed that a return to the 2001 provisions was unacceptable. What was in disagreement—and what we may reasonably expect to be the subject of future disagreement—is the shape of the transfer tax provisions.

Perhaps the most significant lesson to be gained from the debate about the 2010 Tax Act and its provisions is that there will be no long-term certainty about the shape of the federal transfer tax laws in the future. A $5 million exemption and a 35% rate are not cast in stone. We may be moving into a period where the transfer tax exemption and/or the rate(s) are as variable as income tax rates historically have been. More than ever, clients need to stay abreast of legislative developments and to consider how those developments might impact their planning.

What Was Not Changed by the 2010 Tax Act

The 2010 Tax Act did not change what is subject to estate tax. In a nutshell, everything that a person owns (whether alone or jointly) or has the right to designate the beneficiary of (an IRA or life insurance) is potentially subject to federal estate tax. The Act did not change the unlimited marital deduction-whatever is given outright to a spouse or in the form of certain trusts is not subject to tax. The Act did not change the unlimited charitable deduction.

The Act did not change the provisions of the federal gift tax. There is still an unlimited exclusion for payments of tuition and medical expenses; there is an "annual exclusion" that allows for tax-free gifts ($13,000 for 2011); and there is an unlimited marital deduction for gifts to spouses who are U.S. citizens.

The Act did not change the rules governing the valuation of interests in family-controlled entities such as a family limited partnership. The Act did not restrict the term of an interest in a grantor retained annuity trust.

Some Questions About Estate Planning Following the 2010 Tax Act

Should I update my estate planning?

If your Will or Living Trust has a formula clause, you should revisit the planning. What is a formula clause? It is where a disposition of property is defined by reference to a federal tax provision: for example, the amount exempt from federal estate tax, the marital deduction (e.g., "I give to my spouse the least amount necessary to eliminate the federal estate tax"), the GST exemption or the charitable deduction.

Some married clients have "disclaimer planning," where everything is left to the surviving spouse but the spouse has the right to disclaim some or all of the disposition so that it passes to a trust (where typically the spouse is the exclusive beneficiary). The disclaimed amount uses exemption against the estate tax. Generally speaking, the 2010 Tax Act does not affect that planning.

Even if your planning does not contain a formula clause, it may make sense to revisit the planning. The current shape of the federal estate tax is only certain for two years. After that, it is possible that the exemption will decrease (even if a return to a $1 million exemption is unlikely). Clients should consider what would happen under their plan if the federal exemption decreased to $2 million (one of the proposals made in the recent debate).

Does portability mean that I should simply leave everything to my spouse?

The availability of portability eliminates the choice that has confronted many married couples: leave everything to the surviving spouse and lose the use of the exemption of the first spouse to die or use the exemption, thereby requiring the use of a trust if a surviving spouse was to enjoy the economic benefits from the property.

Nonetheless, using portability should not be automatic. Use of a trust at the death of the first spouse may allow for asset management, preserve assets against the costs of long term care or prevent increases in asset values after the death of the first spouse from being taxed in the estate of the surviving spouse. In second marriage situations, use of an "all to the survivor" disposition may not be desirable. Also, planning should account for the possibility that Congress may change the portability rules.

What lifetime planning opportunities are presented by the Act?

The increase of the gift tax exemption to $5 million means that lifetime planning can be done with less concern for the possible imposition of federal gift tax: there is no New York gift tax. Of course, an increase in the exemption should not be the only reason to undertake gifting.

The increase in the exemption may make some estate planning techniques, which were made unattractive by the prospect of paying federal gift tax, viable possibilities. The most prominent example is the Grantor Retained Income Trust (where an individual retains a right to the income from a trust for a specified term of years).

The increase in the exemption should also enhance the attractiveness of other planning techniques, such as Grantor Retained Annuity Trusts and Qualified Personal Residence Trusts.

Does the 2010 Tax Act Affect New York State Estate Tax?

The Act continues the dollar-for-dollar deduction for estate or inheritance tax paid to a state.

New York State continues to have its own estate tax. The threshold for New York estate tax is $1 million: the threshold is not an exemption, however. Once the threshold is exceeded, New York imposes its tax on the entire value of a taxable estate. The marginal rate is between approximately 2% and 16%.

With a federal gift tax exemption of $5 million and no New York gift tax, some consideration can be given to lifetime giving that reduces exposure to New York estate tax. For example, the estate of a person dying with a taxable estate of $1.5 million would pay $64,400 in New York estate tax. If the individual gave to his or her intended beneficiaries $1 million, the New York tax on the remaining $500,000 of assets would be $10,000. ■

We hope that we have provided a good introduction to the 2010 Tax Act. If you have any questions regarding this LEGALcurrents, please do not hesitate to contact any member of our Trusts and Estates Practice Group to schedule a meeting.

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