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Estate Planning Under The 2010 Tax Relief Act

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INTRODUCTION

When President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act") on December 17, 2010, we were presented with both new estate planning opportunities and a continuation of the general uncertainly looming over the transfer tax laws that began with the Bush administration's Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act").

In this short article, we will summarize the key changes in the tax laws under the 2010 Act and explore some of the estate planning approaches and pitfalls under this current scheme. In considering these topics, we urge you to keep two things in mind: first, the new law applies only until the end of 2012, so timely action is required to take advantage of the current rules. Second, tax planning is only one part of estate planning and, with or without tax benefits, it remains important to have an up-to-date estate plan which reflects your goals for the control, management and disposition of your wealth both during your lifetime (especially in the event of your subsequent incapacity) and following your death.

CHANGES IN TRANSFER TAX RULES

While the 2010 Act had an impact on a wide array of taxes, this article will focus on changes to the transfer taxes—gift tax, estate tax and generation-skipping transfer tax ("GSTT").

Beginning in 2002, as a result of the passage of the 2001 Act, the transfer tax rates and the amount of exclusions from those taxes began a steady, scheduled change, culminating in a full repeal of the estate tax and GSTT for one year in 2010. Specifically, while the gift tax exclusion was set at a fixed $1 million beginning in 2002, the exclusion from estate tax and GSTT rose from $1 million in 2002 to $3.5 million in 2009, with a total repeal in 2010. During the same period, the top rate on taxable transfers was reduced from 50% to 45%. Unfortunately, the pre-2002 rules were set to return beginning in 2011 (a $1 million exclusion on any form of taxable transfer and a top tax rate of 55-60%). Estate planners widely believed that Congress would create a more permanent, stable tax regime well before 2010.

Of course, that did not happen. Instead, after almost an entire year without an estate tax, Congress and the President acted late in 2010 to create the 2010 Act, which—with some significant adjustments—effectively re-enacted the law as it existed in 2009 and, in most other respects, kicked the can down the road for two more years. As a result, for 2011 and 2012 only, the top tax rate on taxable transfers is a relatively low 35%, and the exclusion from tax for gifts, estates and generation-skipping transfers is a relatively generous $5 million (with an inflation adjustment to $5,120,000 in 2012). The strange reversion to "old" law which had been set for 2011 is now deferred until 2013—meaning that once again we are left to wait for a more permanent, stable tax regime. Proposals for such changes are already circulating in Washington—as they have for the last ten years without substantive results.

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It is worth a brief mention that special rules were enacted for 2010 under the 2010 Act. While it is clearly too late to do much planning based on those rules, if you had a family member die in 2010, or if large lifetime transfers were made in 2010, you should contact us to discuss the application of the special 2010 tax laws to your situation.

One other key change under the 2010 Act is the concept of "portability." Under prior law, if a person died without fully utilizing his or her transfer tax exclusion, it was lost. Even if that decedent's surviving spouse had a much larger estate which could have taken advantage of the decedent's unused exclusion, that opportunity simply was not available. With the advent of portability, under certain circumstances, a surviving spouse may use his or her predeceased spouse's unused transfer tax exclusion amount, as long as the predeceased spouse dies in 2011 or 2012. No particular lifetime planning is required to take advantage of portability, although properly-conceived estate plans will now address this topic. The election to transfer the unused exclusion to the surviving spouse may have some unintended consequences and requires that an estate tax return be filed for the deceased spouse's estate even if not otherwise due. Note that portability applies only to gift and estate taxes, not to GSTT.

2010 ACT PLANNING APPROACHES

It is important to remember that the new rules apply only for 2011 and 2012—for now. This means that some of the favorable planning opportunities could be extended past 2012, but it also means that they could be significantly reduced or completely eliminated, even for 2012, under proposed alternatives now being discussed in Washington.

Lifetime Gifts

Undoubtedly, the opportunity to make substantial lifetime gifts to take advantage of increased exclusion amounts (up to $5,120,000 per donor) is the most advantageous feature of the 2010 Act. One key benefit of any gift is that any appreciation on the assets transferred—from the date of the gift to the date of the donor's death—escapes the transfer tax system entirely. Another tremendous benefit of lifetime gifts under current law is the opportunity to fractionalize interests in an asset, thereby leading to potential beneficial valuation discounts (and thus lower transfer taxes). Fractionalization can be used to reduce both gift and estate taxes. Caution is required in analyzing the benefits of lifetime gifts, however, because the carryover basis rules can result in the imposition of an eventual capital gains tax when no transfer tax would have been imposed.

Based on the exclusion level in place until the end of 2012, each individual can give up to $5,120,000 in gifts without paying gift tax; additionally, each individual continues to enjoy the availability of additional tax-free gifts courtesy of the annual exclusion (currently $13,000 per donee) and provisions allowing tax-free qualified tuition and medical care gifts. Thus, even those who have already given away $1 million in taxable gifts (fully utilizing the previously available exclusion of $1 million) can now give away an additional $4 million without having to pay any gift tax, plus annual exclusion and qualified tuition and medical care gifts.

One of the uncertainties, however, is the so-called "clawback" or "recapture" which might come into play if the transfer tax level is reduced to less than $5,120,000 in future years. The gift and estate taxes are part of a "*unified tax system,*" and that system is designed to allow only one exclusion of $5,120,000 per person for both gift and estate tax purposes, thereby ensuring that the last dollar transferred is taxed in the highest possible tax bracket. Thus, each transfer (whether during life or at death) is effectively combined with all prior transfers for purposes of determining the total amount transferred, and the tax is initially computed on that amount by a "restoration" of the full exclusion amount available to that person (i.e., as if he or she had never made any prior transfers). The "clawback" concern is that lowering the exclusion in the future essentially will result in the imposition of a tax on previously transferred assets.

A simple example highlights the potential dilemma: Suppose John fully utilizes his $5 million gift tax exclusion by making transfers in 2011. In 2013, when the exemption has been reduced to $1 million, John dies with assets of $500,000. The estate tax is determined by combining all of his taxable gifts and his assets on hand at his death (now totaling $5.5 million) and giving him full credit for the exclusion then available to him, which is only $1 million. That would appear to result in John's estate paying estate taxes on $4.5 mil-

lion in 2013 (a year in which he has transferred only $500,000 as a result of his death), and creating a tax many times in excess of the value of his estate.

Fortunately, many reports indicate that Congress is aware of this issue and is likely to enact corrective legislation to ensure that gifts protected by the exclusion available at the time they are made will not be subjected to a tax in the future as a result of a later reduction in the exclusion amount. Unfortunately, no such law has yet been proposed, let alone passed, so there remains at least some risk that seemingly tax-free gifts could generate an unanticipated tax in the future.

Long-term (“Dynasty”) Trusts

Once you have decided to take advantage of all or part of the current $5,120,000 gift tax exclusion, the form of any new gift should be carefully considered. Building on the idea of making large tax-free gifts during 2011 and 2012, use of a so-called dynasty trust uses both the $5,120,000 GSTT exclusion and the $5,120,000 gift tax exclusion. In this manner, a large amount can be placed into a trust which will continue for the benefit of successive generations of your family, all without being subject to future transfer taxes at your death or at the deaths of the members of succeeding generations. The duration of such a trust is limited only by the old English common-law rule against perpetuities, which in California requires that a non-charitable trust terminate in roughly 90 to 120 years. Of course, you could elect to establish the trust in a jurisdiction which has a very long perpetuities period or even no rule against perpetuities at all (for example, Delaware or Nevada).

Irrevocable Life Insurance Trusts

Another approach would be to fund the purchase of life insurance, perhaps through the use of an irrevocable life insurance trust (designed to keep the life insurance proceeds out of the taxable estate of the insured individual). A substantial amount of life insurance coverage can be purchased for all or part of the $5,120,000 exclusion and used to create a very large—and non-taxable—inheritance for intended beneficiaries. This approach could be coupled with the use of a dynasty trust as described above, resulting in a large fund benefitting multiple generations of your family.

Grantor Trusts

Another variation is to use a current gift to fund a so-called “grantor trust” for the benefit of one or more generations of your descendants. In addition to the regular benefits of making a tax-free gift through a trust, establishing a grantor trust means that the income of the trust would be taxed to the person who established the trust, even if others (for example, children) received all of the benefits from the trust. While this may not sound like an enticing arrangement, it has significant benefits.

Having the grantor pay the income tax on the trust’s income means that the beneficiaries get the full value of the income without reduction for taxes, in essence creating an additional tax-free gift from the grantor to the beneficiaries, year after year.

Note that such a trust can be designed so that the grantor trust treatment can be “turned off” in the future. Thus, if the grantor decides he or she no longer wishes to pay the income tax on the trust’s income, those features can be reversed so that the trust or its beneficiaries will bear the tax burden in the future.

Transactions between the grantor and the grantor trust he or she created are essentially ignored for income tax purposes. Thus, the grantor could sell an appreciated asset to the trust without paying any capital gains tax on that disposition, and the continued appreciation in that asset’s value will result entirely to the trust and its beneficiaries. Such a sale could be made on a highly leveraged basis, getting extra mileage out of the gift used to initially fund the trust. Assets expected to rapidly grow in value are excellent candidates for use in this sort of a transaction.

CONCLUSION

The 2010 Act presents some excellent new planning opportunities, but we don’t know if they will exist after 2012. There are many ideas not covered in this short article and many details which must be considered when planning with the ideas presented above. We are happy to assist you by answering your questions or helping you implement an updated plan to take advantage of these new tax rules.

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