

Federal Tax Update; New Estate & Gift Tax Legislation Alert

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After an unprecedented year of turmoil and confusion, on December 17, 2010 the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” (the 2010 Act) was signed into law. This new act effectuates significant changes to the federal gift, estate tax and generation skipping transfer (GST) tax rules and should be carefully considered in the context of existing and future estate plans. To provide you with an overview of how this new law might affect you, we have prepared this summary of the new law and its anticipated impact, as well as some planning strategies which can be incorporated into your estate plan. For your convenience, the chart included herein provides a comprehensive synopsis of the applicable tax changes.

THE ESTATE TAX

Under the prior law enacted in 2001 by President Bush, there was no federal estate tax due on the estate of an individual dying in 2010, regardless of the size of the estate. While this rule was incredibly generous for estate tax purposes, it carried with it some negative income tax consequences, as it provided for a limited ability to increase or “step-up” the basis in inherited property to date of death values for income tax purposes. More importantly, on January 1, 2011, the tax law in effect prior to 2001 would have brought about a revival of the federal estate tax, with an estate, gift and GST exemption amount of \$1,000,000 per individual and estate tax rates of up to 55%. Only the GST exemption amount would have been adjusted for inflation since 2001.

By contrast, the 2010 Act gives estates of decedents who died in 2010, the ability to opt-out of the revived estate tax. It gives those estates the option to elect to (1) apply the estate tax based on the new 35% top tax rate and \$5 million exemption, with a full step-up in tax basis or (2) opt-out of the revived estate tax resulting

in no estate tax due, but a limited ability to step-up the estate beneficiary’s tax basis in inherited property to date of death values for income tax purposes. The basis adjustment is limited to \$1,300,000 plus an additional \$3 million passing to a surviving spouse. Once made, any election would be revocable only with the consent of the IRS.

Looking ahead under the new law, estates of those decedents dying in 2011 or 2012 will be subject to a generous \$5,000,000 estate tax exemption (with a 35% maximum tax rate on the excess) and an unlimited ability to step-up the tax basis in inherited property to the value at the time of the decedent’s date of death. Additionally, under certain circumstances, a surviving spouse may utilize the unused estate tax exemption of a pre-deceased spouse (a concept known as “portability” as discussed more thoroughly below). However, New York State only provides for a \$1,000,000 estate tax exemption and no portability of unused estate tax exemption between spouses, while New Jersey’s exemption is \$675,000 and Connecticut’s exemption is \$3.5 million both having no portability, as well.

The 2010 Act also extended the time to file a federal estate tax return, for a decedent who died during the period of time from January 1, 2010 to the day before the date of enactment, until September 19, 2011, which is nine months after the date of enactment. It should be noted however, that the traditional state estate tax deadlines are unaffected by the federal extension.

THE GIFT TAX

In 2010, an individual could make up to \$1,000,000 in lifetime gifts, (in addition to gifts made under the annual exclusion amount), free of gift tax. Gifts in excess of this amount were subject to a 35% federal gift tax. Pursuant to the 2010 Act, beginning in 2011, the federal gift tax exemption will be “reunited” with the federal estate tax exemption, meaning that each

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individual will have a lifetime gift tax exemption of \$5,000,000. This dramatically increased exemption provides tremendous opportunities for estate planning, especially considering the current economic climate where interest rates remain at historically low levels and asset values are significantly depressed.

The annual gift tax exclusion for 2011 remains at \$13,000 per person per calendar year, or \$26,000 for married couples, as gift splitting is still permitted. Additionally, there remains an unlimited exclusion for transfers made for medical or educational purposes, if the transfer is made directly to the medical service provider or educational institution.



GENERATION-SKIPPING TRANSFER TAX

Generally, the Generation Skipping Transfer (GST) tax applies to those transfers made from an individual to his or her grandchild or more remote descendants or to a trust for their benefit. The GST prevents a taxpayer from avoiding the transfer tax by bypassing the generation below them (e.g. children). The rate of GST tax is generally the highest applicable estate tax rate.

Prior to the 2010 Act, the GST tax did not apply for property transfers in 2010 but would apply in 2011. The GST exemption amount was scheduled to return at approximately \$1.3 million (indexed for inflation since 2001).

Under the 2010 Act, the GST tax is retroactively reinstated for 2010. However, the GST tax rate for 2010 is zero percent (0%). Therefore, while an outright transfer made in 2010 by an individual to his grandchild is technically subject to GST tax, practically speaking, based on the applicable 0% tax rate, there would be no GST tax due. For 2011 and 2012, the GST exemption amount is increased to \$5,000,000, and is indexed for inflation after 2011. This generous exemption amount creates unprecedented opportunities for the inter-generational transfer of wealth with significantly reduced transfer tax consequences.

PORTABILITY

The 2010 Act provides for portability between spouses of the \$5 million estate tax exemption amount for estates of decedents dying in 2011 or 2012. This option is available only in the event that both spouses die after 2010 but before 2013. Under this new portability provision, the surviving spouse can use such unused portion of the last deceased spouse's estate tax exemption.

The surviving spouse can use such unused portion for both gift tax and estate tax purposes, but NOT for GST tax purposes and it does not apply to state death tax exemptions. This new rule differs greatly from the prior system which did not allow for the surviving spouse to utilize the deceased spouse's unused exemption amount, and often required the use of a by-pass trust or credit shelter trust which added a level of complexity.

In order to preserve the unused estate tax exemption amount for the surviving spouse, an election must be made on a timely filed estate tax return for the deceased spouse. Additionally, careful consideration must be given to the fact that the portability benefit is limited to the unused estate tax exemption of the last deceased spouse of the surviving spouse. This rule is clearly aimed at avoiding "serial marriages" to accumulate unused exemption, but may have further implications in whether a surviving spouse decides to remarry and risk losing his or her prior spouse's unused exemption amount, or in choosing who he or she remarries based on their unused exemption amount.

PLANNING POINTS

- While the 2010 Act has effectuated major changes, it is important to note that state law is unaffected by the Act. For example New York State's estate and inheritance taxes remain at a \$1 million exemption—significantly lower than the new \$5 million federal exemption. For example, a 2011 NYS resident decedent with an estate of \$5 million could be subject to a state estate tax of \$391,600 (absent any marital or charitable deduction). Therefore, careful consideration must be given as to the State Estate tax consequences for those clients looking to take full benefit of the increased Federal exemption amount.
- For estates of 2010 decedents, the 2010 Act created significant post-mortem tax planning opportunities, particularly to avoid GST taxes on transfers to more remote generations. However, these opportunities are time sensitive and should be considered immediately. For example, the new law extends the nine month period in which individuals may disclaim an interest in property to September 19, 2011.
- The increase in the gift tax exemption to \$5 million creates additional opportunities in 2011 and 2012 to make lifetime transfers to avoid estate taxes on post transfer income

and appreciation, and to transfer assets to grandchildren and future generations.

- Although portability is a positive development, the use of a by-pass trust should be considered since it can shield future income and appreciation from transfer tax and can provide asset protection.
- Any estate plans contain formula clauses which are tied to estate and GST exemption amounts. These plans should be reviewed since the amounts passing under these formulas could vary widely as the exemption fluctuates and may not result in what the transferor intended.
- The increased estate tax exemption under the new law does not apply to non-resident aliens. Such individuals should pay particular attention to the prior law.
- The 2010 Act does not amend the rules relating to Grantor Retained Annuity Trusts (GRATs) to include a minimum

trust term, as many experts had predicted it would. Therefore, the use of short term GRATs as part of the larger estate plan continues to be both a viable and valuable strategy.

- The 2010 Act does not contain any provisions regarding valuation discounts for gift and estate tax purposes. Therefore, estate planning techniques which incorporate such discounts, such as the sale of assets to an Intentionally Defective Grantor Trust (IDGTs) continue to be an important tool.

EXPIRATION OF THE 2010 ACT

The provisions and applicable rates created by this 2010 Act are scheduled to sunset after December 31, 2012. Without further legislative action, the law in 2013 will revert back to the pre 2001 rules with a \$1 million gift and estate tax exemption, a 55% estate, gift and GST maximum tax rate, and no portability of the estate tax exemption between spouses.

SUMMARY

In light of the extensive overhaul of the Federal estate, gift and generation skipping tax infrastructure, we strongly advise that our clients review their current estate plan to ensure that the strategies in place adequately protect their interests. This is especially true for those clients whose documents rely on formula provisions which, based on the higher exemption rates provided under the 2010 Act, could substantially undermine the original intent for the disposition of assets. Further, clients should take advantage of the increased exemption amounts and new opportunities for multi-generational estate planning.



	2009 (OLD law)	2010 (Retroactive under NEW Act)	2011 (Under NEW Act)	2012 (Under NEW Act)
Estate Tax Exemption	\$3.5 million	Election between: \$5 million or no estate tax	\$5 million and portability	\$5 million, indexed for inflation since 2010 and portability
Maximum Estate Tax Rate	45%	35%	35%	35%
Basis Adjustment at Death	Unlimited	Election between Unlimited or \$1.3 million general and \$3 million spousal	Unlimited	Unlimited
GST Tax Exemption	\$3.5 million	\$5 million	\$5 million No portability	\$5 million, indexed for inflation since 2010; No portability
Maximum GST Tax Rate	45%	0%	35%	35%
Maximum Gift Tax Rate	45%	35%	35%	35%
Lifetime Gift Tax Exemption	\$1 million	\$1 million	\$5 million (with portability)	\$5 million, indexed (with portability)

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