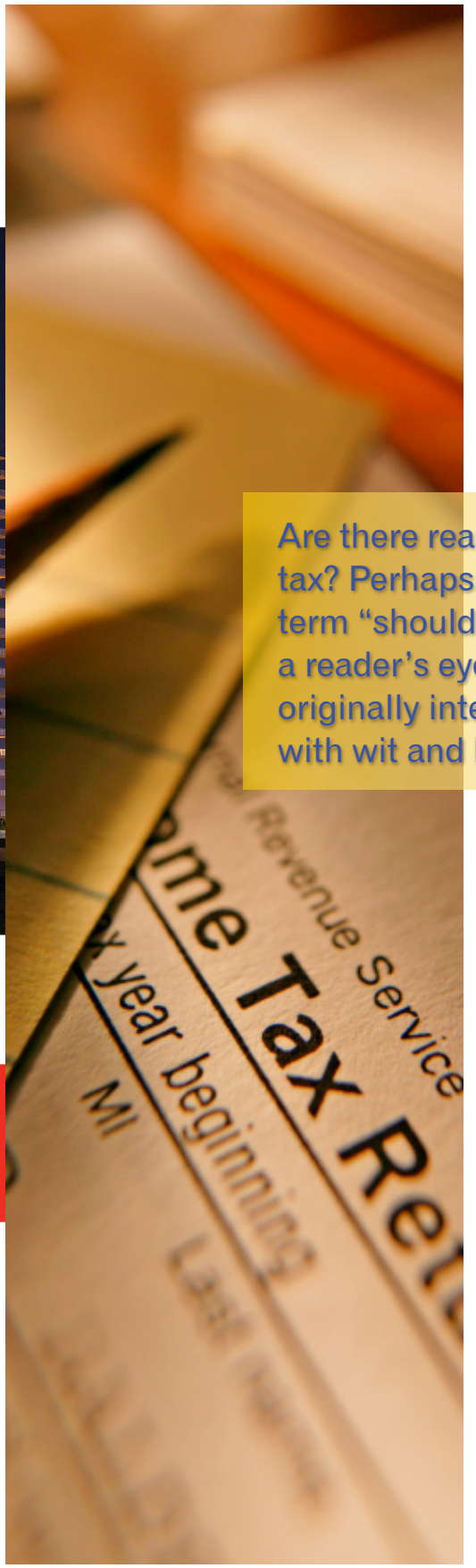

NOTHING IS CERTAIN BUT DEATH AND TAXES, SO WHAT ABOUT THE ESTATE TAX?

BY NICOLE M. VANCE, ESQ.

Ten things you want to know about the new federal estate tax regime

Are there really 10 things anyone "wants" to know about the estate tax? Perhaps the title of this article should more appropriately use the term "should" or "need." This having been said, attempting to catch a reader's eye with this topic is challenging. In fact, this article was originally intended to be a Letterman style "Top Ten" list, sprinkled with wit and humor and followed with an uproarious punch line.

Unfortunately, the realization soon hit that there is little opportunity for wit or humor surrounding the estate tax, much less any uproarious or even amusing punch lines. Therefore, rather than continuing to spin my wheels trying to channel my inner comedian, I stepped back into my estate planner role to do what I do best: provide straightforward information.

This information is important for one reason: clients want to understand the estate tax and how it affects them. Moreover, the estate tax itself is a political football that has been thrown around for years and is not likely be taken out of play any time soon. As evidenced this past December, the estate tax can become a key bargaining chip in the high-stakes negotiation game that is politics today. Finally, the estate tax may affect you personally or your family and your friends.

1. The Three Federal Transfer Taxes Remain in Place

The estate, gift and generation-skipping transfer (GST) taxes remain in effect today. The estate tax applies to transfers at death and the gift tax applies to transfers during life. The GST tax is an additional level of tax imposed on transfers to "skip persons" such as grandchildren and certain other individuals and trusts.[1] Transfer taxes do not apply to transfers that fall within applicable "exemption amounts[2]" for each tax.

In recent years, estate planning has been challenging due to changing rates and exemptions under the Economic Growth and Tax Relief Reconciliation Action of 2001 (EGTRRA). Last year was particularly difficult, given the uncertainty surrounding the repeal of the estate and GST taxes. Under EGTRRA, transfer tax rates decreased

continued on page 16

NOTHING IS CERTAIN BUT DEATH AND TAXES, SO WHAT ABOUT THE ESTATE TAX?

continued from page 15

and exemptions increased from 2001 through 2009, culminating in 2010 with a one-year repeal of the estate and GST taxes and the lowest gift tax rate in history.[3] Under EGTRRA's "sunset" provision,[4] all changes were scheduled to expire in 2010, such that estate and GST taxes would return in 2011 at higher rates and significantly lower exemptions. Up until late last year, most if not all estate planners believed we would see higher transfer taxes for 2011, especially given the unexpected Congressional failure to act in 2009 to prevent the 2010 repeal. Most of us were proven wrong once again.

In December 2010, the president signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRA 2010). TRA 2010 went into effect less than two weeks before transfer taxes were scheduled to substantially increase in 2011, due to 55 percent maximum tax rates and $1 million exemptions. TRA 2010 provides for significant decreases in transfer taxes.

2. Transfer Taxes Are Lower Due to Tax Rate Decreases and Exemption Increases

Transfer taxes for 2011 and 2012 are now at historical lows, with a 35 percent maximum rate and $5 million exemption for each tax.[5] In addition, exemptions are inflation indexed for 2012. For 2010, rates and exemptions are the same except that:

1. estates of decedents can elect no estate tax for 2010 (see below);
2. the GST tax rate is 0 percent; and
3. the lifetime gift tax exemption stays at $1 million.[6]

The annual gift tax exemption remains at $13,000, meaning an individual can make tax-free transfers of $13,000 each year to as many people as desired in addition to the $5 million lifetime exemption.

With reunification of the estate and gift taxes, the exemption is the same for both taxes and assets up to $5 million may be transferred either during lifetime or at death. Prior to reunification, tax-free lifetime transfers could be made only up to the annual and lifetime gift tax exemption amounts, even if such transfers were below the remaining estate tax exemption. For example, in 2009 when the lifetime gift and estate tax exemptions were $1 million and $3.5 million, respectively, an individual with no remaining annual exemption would have to pay gift tax on lifetime transfers exceeding $1 million, even though there would still be $2.5 million left in estate tax exemption. With reunification, tax-free lifetime transfers can be made up to the estate tax exemption amount.

3. Portability Provision Allows Surviving Spouse to Use Exemption of Deceased Spouse

Under TRA 2010 a surviving spouse may use any remaining estate tax exemption of the first spouse to die.[7] The exemption[8] may be used in addition to the survivor's own exemption, for either lifetime gifts or transfers made at death. For remarriage situations, the survivor may use the exemption of the most recently deceased spouse only, such that no more than $10 million of exemption is available to any one individual. Portability does not apply to the GST tax exemption.

Exemption portability is available for 2011 and 2012 but disappears in 2013 absent further Congressional action.[9] Practically, this means portability applies only if the first spouse dies in 2011 or 2012 and the second dies before 2013. For portability to apply, a Form 706 estate tax return must be filed and an election made to permit use of the remaining exemption. Consequently, small estates that would not otherwise be required to file must do so to preserve the unused exemption for the survivor.

As married couples can now transfer up to $10 million tax-free, speculation abounds as to whether there will be a perceived lesser need for comprehensive estate planning. In 2010 and prior years, any unused exemption of the first spouse to die was lost at death. To avoid this situation, various planning strategies were employed to maximize the exemption, including lifetime gifting and distributions at death to non-spouse beneficiaries. The most prevalent strategy used to preserve the exemption was the bypass (or "credit shelter") trust. Given the portability provision, the question arises as to whether bypass trusts are still necessary.

There are many compelling reasons to use the bypass structure rather than rely on portability. First and perhaps most importantly, the portability provision expires after 2012. Second, a bypass trust shields appreciation in underlying assets from further estate tax. Third, the bypass structure protects against loss of the deceased spouse's exemption in the event the survivor remarries and is again widowed. Fourth, portability does not

continued on page 18

NOTHING IS CERTAIN BUT DEATH AND TAXES, SO WHAT ABOUT THE ESTATE TAX?

continued from page 16

apply to the GST tax exemption. Finally, a bypass trust offers many of the traditional advantages of trusts, including both asset protection and asset preservation for the deceased spouse's intended heirs. Although there are some advantages to portability, the decision to forego the bypass structure should be made in light of the temporary nature of portability as well as the numerous advantages of the bypass trust.

4. Return to Step Up Basis Regime Results in Lower Federal Capital Gains Taxes

In 2011 and 2012, capital gains on inherited assets will once again be determined under a step up rather than a modified carry-over basis regime. In addition, basis step up is the default rule for 2010. The return to step-up basis will generally result in lower federal capital gains taxes for heirs that inherit appreciated assets. This is because an heir's income tax basis in inherited assets under the step up regime is the assets' date of death value. Immediate sale of the assets does not give rise to capital gain since basis is the same as date of death value. In contrast, under the modified carryover basis rules, an heir's basis is equal to the lesser of:

1. the deceased person's asset basis; or
2. the date of death value of assets.[10]

In such a case, limited basis increases are permitted through the $1.3 million general and $3 million spousal adjustments; however, such adjustments are limited to assets' date of death value.[11] As compared to the step-up basis regime, immediate sale of appreciated assets results in capital gain.

5. Form 706 Estate Tax Return Filing Deadline and Payment of Tax is Extended

TRA 2010 extends the deadline for filing the estate tax return and paying the tax. The Form 706 must be filed and payment made by the later of:

1. nine months after date of death, or
2. nine months after enactment of TRA 2010.[12]

This extension is available only for estates of decedents that died in 2010 prior to enactment of the new law. As TRA 2010 was enacted December 17, 2010, the estate tax return and payment for qualifying estates will be due September 17, 2011.

6. Decedents' Estates Subject to Estate Tax for 2010 Unless Election Made to Opt Out

The new law provides two options for estates of persons that died in 2010. Under the default rule, estate tax will automatically apply at a 35 percent maximum rate, with a $5 million exemption and a step up in basis for appreciated assets.[13] In contrast, the executor may elect to opt out of the estate tax but will then be subject to the modified carryover basis regime for appreciated assets.[14] For estates falling within the exemption amount, electing out of the estate tax generally does not make sense. For larger estates, further analysis is necessary to determine whether the election to opt out is best given the related income tax cost.

7. Recent Changes in Transfer Tax Laws Are Only Temporary

The transfer tax rate and exemption changes apply for 2011 and 2012 only. For 2013, portability is no longer available and transfer taxes substantially increase, with a 55 percent maximum rate and $1 million exemption for each transfer tax. Congressional action before 2013 could change this; however, we have no idea whether such action will occur and if so what changes would result. Therefore, the current regime is temporary and long-term estate planning remains challenging.

8. Existing Estate Plans May Have Issues Due to Formula Allocation Provisions

Formula allocation provisions in existing estate plans may give rise to unanticipated consequences for heirs. Children or spouses may receive substantially more or less than intended because the exemption amount has significantly increased yet the language in many estate planning documents ties inheritance amounts to the exemption amount. For example, an estate plan created in 2005 when

the exemption was $1.5 million may provide that children receive assets equal to the exemption amount and surviving spouse receives the balance. Based on a $10 million net worth, clients likely intended at plan creation for children to receive only $1.5 million and spouse to receive the $8.5 million balance. Instead, under today's laws, children receive $5 million and spouse receives only $5 million.

A similar situation may result in remarriage situations where a client wants to preserve assets for children and provide less to the surviving spouse. In such a case, the spouse could receive much more than intended. In addition, language tied to the exemption amount may result in a lesser than expected degree of asset and creditor protection for beneficiaries. For these reasons and others, review of existing estate plans is imperative.

9. Significant Planning Opportunities Exist for 2011 and 2012

The opportunity for wealth transfer planning is better than ever for 2011 and 2012. This is primarily due to the lowest transfer tax rates and highest exemptions in modern times. In addition, although many were concerned that new legislation would limit valuation discounts and/or restrict the use of grantor retained annuity trusts, TRA 2010 includes no such provisions. Finally, asset values remain depressed and interest rates are at historical lows. For those desiring to capitalize on this window of opportunity, asset transfer strategies generally fall into two categories – nontaxable gifting and taxable gifting.

With respect to nontaxable lifetime transfers, individuals may transfer up to $5 million and married couples may transfer up to $10 million. Even those that have already made lifetime gifts of $1 million can gift an additional $4 million without incurring gift tax. Note that there is some risk inherent in making such gifts. This is because the estate tax exemption is scheduled to decrease to $1 million in 2013, yet the new law does not contemplate an estate tax exemption lower than the current $5 million gift tax exemption. Accordingly, there is much current debate as to whether recapture of

continued on page 20

NOTHING IS CERTAIN BUT DEATH AND TAXES, SO WHAT ABOUT THE ESTATE TAX?

continued from page 19

transfers in excess of the estate tax exemption could be required.

For those wanting to transfer additional assets out of their estate after using up the lifetime exemption, taxable gifting is a good strategy since the tax rate is only 35 percent. In addition, lifetime gifting is generally more tax efficient than making transfers at death.

10. Attorneys Should Inform Clients of Changes and Recommend Review of Existing Estate Plans

Given the significant changes in the laws, potential issues in existing estate plans and current opportunities for wealth transfer planning, attorneys should inform clients that the transfer tax laws have substantially changed and recommend review of existing estate plans. Trust and estate attorneys should consider sending client letters to:

1) summarize the recent changes; and
2) recommend meeting to further discuss the transfer taxes and client specific issues and opportunities.

Attorneys should also review their own estate planning.

Conclusion

In summary, I quote a question clients frequently ask: will we ever see the death of the estate tax? Given the recent changes, one may conclude that we are headed in that direction; however, the fact remains that 2013 is expected to bring the highest rates and lowest exemptions in recent years. Moreover, the political climate is a key factor in the ultimate outcome and we cannot predict what will happen in the 2012 elections and years to follow. Finally, our deficit is at a record high and prospects for reduction do not look good. In summary, I conclude with the old adage that nothing is certain but death and taxes. As the estate tax is the ultimate juxtaposition of death and taxes, I'm guessing the estate tax will not die anytime soon. ■

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1 Internal Revenue Code (IRC) Section 2613.
2 The terms "exemption" and "exemption amount" are not technically correct because the calculation of estate tax involves a credit rather than a true "exemption." The tax due on a taxable estate is reduced on a dollar-for-dollar basis by the "unified credit" allowed under IRC Section 2010. However, since this credit is often referred to as the "exemption equivalent," throughout this article this exemption equivalent amount will be referred to as the "exemption" or "exemption amount."
3 P.L. 107-16
4 P.L. 107-16, Section 901.
5 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010) Sections 302(a)(1), 302(a)(2).
6 TRA 2010 Sections 301(c), 302(b)(1)(B), 302(c), 302(f).
7 TRA 2010 Section 303.
8 The exemption of the first spouse to die is technically referred to as the "Deceased Spousal Unused Exclusion Amount" or "DSUEA."
9 TRA 2010 Section 303(c)(1).
10 IRC Section 1022(a).
11 IRC Sections 1022(b), 1022(c), 1022(d)(2).
12 TRA 2010 Section 301(d).
13 TRA 2010 Sections 302(a)(1), 302(a)(2), 302(f).
14 TRA 2010 Section 301(c).

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NOTHING IS CERTAIN BUT DEATH AND TAXES, SO WHAT ABOUT THE ESTATE TAX?

Ten Things You Want To Know About the New Federal Estate Tax Regime

1. The three federal transfer taxes were eliminated by TRA 2010.
True or False

2. TRA 2010 was enacted less than two weeks before transfer taxes were expected to substantially increase in 2011.
True or False

3. Exemptions are inflation indexed for 2011 and 2012.
True or False

4. For 2010, the GST tax rate is 35 percent and the lifetime gift tax exemption is $5 million.
True or False

5. The annual gift tax exemption amount remains at $13,000, meaning an individual can make tax-free transfers of up to $13,000 each year to as many people as desired in addition to the $5 million that can be gifted during life.
True or False

6. The estate and gift taxes have been reunified, such that an individual can make tax-free lifetime gifts of up to $5 million.
True or False

7. A Form 706 estate tax return is not required for the portability provision to apply.
True or False

8. A credit shelter trust is no longer required to preserve the estate tax exemption of the first spouse to die.
True or False

9. Under a step-up basis regime, an heir's income tax basis in inherited assets is the deceased person's asset basis.
True or False

10. The deadline for filing the estate tax return and paying the estate tax is September 17, 2011 for all estates of decedents that died in 2010 prior to enactment of TRA 2010.
True or False

11. For 2010, the default rule is no estate tax and a modified carryover basis regime.
True or False

12. The changes in the transfer tax laws apply for 2011 and 2012 and rates and exemptions will change again in 2013.
True or False

13. Existing estate plans may be affected by the recent changes in the transfer tax laws but will not result in unintended inheritances or decreased asset/creditor protection.
True or False

14. 2011 and 2012 are ideal years for wealth transfer planning given the increased lifetime gift tax exemption and the low gift tax rate of 35 percent.
True or False

15. Attorneys need not advise their clients that the transfer tax laws have changed.
True or False

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