Estate Planning After the Tax Act of 2010

July 27, 2011

President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 on December 17, 2010 (the Act). This hastily negotiated legislation was enacted to address the sunset of the tax rates established by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA had enacted a scheme of steadily increasing estate tax exemption amounts and steadily decreasing rates, which culminated in repeal of the estate tax for one year (2010), followed by a reinstatement of pre-2001 tax rates in 2011.

Chief among the purposes of the Act was a reinstatement of the estate tax, but with more favorable provisions. As in 2001, however, Congress' inability to agree on permanent characteristics of the tax law led to enactment of temporary legislation: the tax provisions of the Act are set to expire on December 31, 2012. Whether or not the Act will sunset on that date, causing tax rates to revert to pre-2001 levels, is unclear. But, within this two year window, Clients may take advantage of the Act's favorable provisions.

Favorable Provisions of the Act

1. Increased Exemption Amount and Reduced Rate

The Act increases the estate and gift tax exemption amounts to $5 million each, effectively reunifying the exemption amounts for the first time since 2001. In 2009, the estate tax exemption amount was $3.5 million, and the gift tax exemption had been frozen at $1 million since 2001. Thus, clients can now shelter up to $5 million of estate assets by lifetime gift or at death. In the case of married couples, each spouse will have a $5 million exemption, for a combined total $10 million exemption amount.

In 2009 the top estate tax rate was 35 percent, down from 55 percent in 2001. However, the gift tax rate had been frozen at 55 percent since 2001. The Act maintains the top estate tax rate at 35 percent and, in keeping with the reunification theme, reduces the gift tax rate to 35 percent.

The generation-skipping transfer (GST) tax has mirrored the gift tax since 2001 with a 55 percent rate and a $1 million exemption. The Act reduced the GST rate to 35 percent and increased the exemption amount to $5 million.

2. Modified Carryover Basis Rules

Decedents dying in 2010 generally were not subject to the estate tax. As a result, their heirs received the assets of their estates with a carryover basis, as opposed to a "step-up" in basis that pre-2010 heirs would have received. The Act provides that the executors of 2010 estates may opt to be subject to the estate tax, and thereby create a step-up in basis, or elect not to be subject to the estate tax, in which case the carryover basis rules will apply. The carryover basis rules are otherwise repealed for calendar years following 2010.

3. Portability

For the first time, the Act allows for portability between spouses of any unused exemption amount upon the first spouse's death. For example, if the first spouse to die has used only $1 million of his exemption amount, the remaining $4 million exemption may be utilized by the surviving spouse in addition to her own $5 million exemption amount. Portability must be elected by the executor of the first spouse to die by the filing of an estate tax return, whether or not the decedent had a taxable estate.

4. Extension of Filing Deadlines

The executors of the estates of decedents dying after December 31, 2009 and before December 17, 2010 will have until September 17, 2011 to file the decedent's tax return, pay the estate tax or make a qualified disclaimer.

Planning Opportunities

The provisions of the Act create a number of planning opportunities. The reunification of the estate and gift taxes means that a client may choose to remove assets from his or her estate during life without the unfavorable tax result that would have occurred when the gift tax exclusion was only $1 million and the rate was 55 percent. If a client has certain assets that are expected to appreciate significantly in value before death, it may be advantageous to transfer the assets during lifetime when their relative value is lower, which will use less of the $5 million exemption than would be used if the assets remained in the client's estate at death. Also, the use of the increased gift tax exemption prior to the sunset of the Act may be a "use it or lose it" proposition, as it is unclear whether these provisions will be continued beyond the end of 2012. A client may even choose to make simple taxable gifts in excess of the $5 million exemption amount during the next two years, as the potential remains that the gift tax rate will revert to 55% after 2012.

Traditional methods of leveraged and split-interest gifts may further enhance the value that may be transferred during a client's lifetime. In particular, clients may utilize grantor retained annuity trusts (GRATs), defective grantor trusts or qualified personal residence trusts to leverage and freeze the value of lifetime gifts. The use of family entities, such as family limited partnerships and limited liability companies, remain a viable method for transferring family wealth and business interests in a leveraged medium. However, with the increased estate and gift tax exemption amounts, many clients are finding that the restrictions and complexities of a family entity are sometimes too cumbersome to justify its use as a planning device when compared to the potential tax savings.

Before committing to making such large lifetime gifts, a donor should consider the potential impact of the gift. Attempting to transfer the maximum wealth possible could potentially leave the donor in a position of having inadequate resources prior to death. In addition, a sudden unrestricted access to wealth could have a negative impact on a donee who is fiscally undisciplined or lacks maturity.

A partial solution to unrestricted gifts is the use of trusts to provide a donee with more limited and structured access to wealth. However, the donor should consider the irrevocable nature of these transfers and the difficulty in modifying core trust terms. Another option in family business contexts is the use of family entities.

Despite the introduction of portability, clients may well be advised to adopt a traditional credit shelter form of estate planning. Use of traditional planning techniques will ensure that the full $5 million exemption per spouse is utilized, and that the exempted assets will pass to the intended heirs. Failure to utilize a credit shelter trust when a spouse's estate contains assets with a potential for appreciation will expose the surviving spouse's estate to potential tax on that appreciation.

The portability provisions also create a potential trap for the unwary, as portability is unavailable to an estate if the pre-deceasing spouse did not file an estate tax return that elected portability. Because of the potential for estate tax liability, borderline estates (those with approximately $10 million in combined assets) should be especially careful about adopting a structured credit shelter estate plan.

Conclusion

The Act creates a unique estate planning environment for the next two years. Clients should carefully consider the use of significant lifetime gifts to take advantage of the favorable re-unified estate and gift tax rates. In addition, clients should continue to use traditional estate planning techniques to maximize the value of transferred wealth at the lowest tax rate and to avoid the potential pitfalls of relying on portability.