

ALERT

ESTATE PLANNING OVERVIEW AND OBSERVATIONS OF THE 2010 TAX ACT

January 26, 2011

On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act") became law. The Act provides estate planning opportunities that have never been available. However, the Act is temporary. It is structured to sunset on December 31, 2012, so its opportunities have a two-year window. With an increased estate tax exemption, an individual might be tempted to do nothing when the law is in flux. That may be a big mistake.

Overview of the Act

- Lower estate tax rate and higher estate tax exemption for 2011 and 2012. For estates of individuals dying in 2009, the top estate tax rate was 45% and there was a \$3.5 million exemption. The top rate was to rise to 55% for estates of individuals dying after 2010, and the exemption was to be \$1 million. For 2011 and 2012, the Act reduces the top rate to 35%. It also increases the exemption to \$5 million for 2011 with a further increase for inflation in 2012. However, these changes are temporary. After 2012, the top rate will be 55%, and the exemption will be \$1 million.
- Gift tax changes. Over the last ten years, the **estate** tax exemption has steadily increased from \$1 million in 2001 to \$3.5 million by 2009. However, the **gift** tax exemption stayed at a fixed amount of \$1 million. The Act increased the gift exemption to \$5 million beginning January 1, 2011. The gift tax rate was also reduced to 35%. After 2012, the gift tax exemption goes back to \$1 million and the gift tax rate goes back to 55%.
- Generation-skipping transfer (GST) tax changes. The GST tax is an additional tax on gifts to grandchildren when their parents are still alive. The Act lowers GST taxes for 2011 and 2012 by increasing the exemption amount from \$1 million to \$5 million and reducing the rate from 55% to 35%.
- New "portability" feature. The Act allows the personal representative of a deceased spouse's estate to transfer any unused estate tax exemption to a surviving spouse, allowing the couples' estates to enjoy the full \$10 million estate tax exemption, regardless of the size of the predeceased spouse's estate.
- Special election for 2010 estates. The personal representative of a person who died in 2010 may elect (i) to pay estate taxes with a \$5 million exemption and receive a step-up in the income tax basis to current market value, or (ii) elect out of the estate tax system and carry-over the decedent's income tax basis to the estate beneficiaries.

Observations

To determine whether the Act may provide tax savings opportunities, we have divided potential estates (net worth plus life insurance) into three general categories, as follows:

- Estates less than \$1 million. The Act has very little, if any, impact on estates under \$1 million. All plans should be reviewed to make sure the estate is properly designed to transfer assets to the intended beneficiaries. As the estate value approaches \$1 million, a tax analysis should be conducted.
- Estates equal to or greater than \$1 million and less than \$10 million. Based upon the wide fluctuation of estate tax exemptions that have occurred and are expected to occur in the future, it is critical to review any estate plan that is formula based. For example, a direction to transfer the maximum amount that can avoid estate tax to a family trust and any excess amount to a marital trust is a formula based plan.

Also, with estate tax exemptions of up to \$10 million per couple, a properly designed plan should now balance estate tax planning with income tax planning. For example, if the combined estates of both spouses is not expected to exceed \$10 million at the surviving spouse's death, planning should allow all assets to be included in the surviving spouse's estate to obtain a step-up in income tax basis. This will require many plans to be updated.

As an estate approaches \$10 million, additional planning should be considered.

- Estates equal to or greater than \$10 million. Prior to January 1, 2011, an individual could only make large tax-free gifts totaling \$1 million during his or her lifetime, or a combined \$2 million for a husband and wife. Now, the Act allows EACH spouse to gift up to \$5 million without incurring any gift tax. The gift tax exemption could be maximized by transferring discounted assets such as closely-held stock. Additionally, the gift tax exemption could be leveraged with a combination of gifts followed by a sale of assets in exchange for a promissory note to transfer additional assets without incurring a gift tax.

Concerned about how much you can afford to give? Include your spouse as one of several permissible beneficiaries. Alternatively, each spouse may set up a trust for each other to exhaust his or her own \$5 million lifetime federal gift tax exemption. Additionally, if gifts are made to a "grantor" trust, all income tax is paid by the donor, allowing the gifted assets to grow income tax free inside the trust. Careful planning is required to avoid potential tax traps.

The world of estate planning shifted considerably when the Act passed. There is no "one size fits all" plan that applies to all cases. There is, however, more opportunity to engage in active, tax efficient planning now than has ever been available. There is no certainty what will happen beyond December 31, 2012. The time for planning is now.

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