January 19, 2011

2010 Tax Law Changes Lessen Tax Burden on Estates and Create Planning Opportunities

On December 17, 2010 the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Act) was enacted. It extends, through 2012, many tax relief provisions that were scheduled to expire as of January 1, 2011, and substantially reduces the likelihood of individuals being subject to, and under the burden of, estate, gift and generation skipping transfer (GST) taxes. The 2010 Tax Act offers important planning opportunities, but also contains potential traps for the unwary. Hahn Loeser's Estate Planning, Wealth Transfer and Preservation practice attorneys are ready to help you take advantage of the opportunities while avoiding those traps.

What Changed for 2010 (and What Did Not)?

- The federal estate tax, that prior to the enactment of the 2010 Tax Act had been suspended for estates of individuals dying in 2010, is reinstated with an applicable exclusion amount of $5 million and a flat tax rate of 35%. In addition, the income tax basis in each asset passing from the decedent will be adjusted to the asset's estate tax value.
- Estates may elect out of the reinstated estate tax. The trade off for having no estate tax apply is the loss of the automatic income tax basis adjustment for appreciated assets and the application of the modified carryover basis rules that applied for 2010 prior to the enactment of the 2010 Tax Act.
- The GST tax is reinstated, with a 0% tax rate applicable in 2010 only.
- A GST exemption of $5 million will be available for allocation to gifts made in 2010 and to transfers made by an individual dying in 2010. Prior to the enactment of the 2010 Tax Act, no GST exemption was available to allocate in 2010.
- Outright gifts to grandchildren in 2010 and certain gifts in 2010 made in trust for the benefit of grandchildren will not require any allocation of GST exemption in 2011, however, care must be taken to avoid unnecessary automatic allocation of GST exemption. Timely filing of 2010 gift tax returns making the required elections "out" of automatic allocation of GST exemption is essential.
- The gift tax applicable exclusion amount remains at $1 million in 2010 and the tax rate at 35%.

What's New in 2011 and 2012?

- The federal estate tax will have an applicable exclusion amount of $5 million and a flat tax rate of 35%. Without the enactment of the 2010 Tax Act, the estate tax would have returned to pre-2002 levels on January 1, 2011—returning to a $1 million applicable exclusion amount and a maximum 55% tax rate.
- The gift tax applicable exclusion amount is reunified with the estate tax applicable exclusion amount at $5 million and the tax rate remains a flat 35%.
- Any unused portion of the $5 million applicable exclusion amount of a married person who is the first spouse to die may be "transferred" to the surviving spouse to insure that combined applicable exclusion amounts of up to $10 million may be used in both spouses' estates. This feature is sometimes referred to as "portability."

- The GST exemption is $5 million and the GST tax rate is 35%. The GST exemption is not "portable" between spouses.
- The estate and gift tax applicable exclusion amount and the GST exemption will be indexed for inflation, beginning in 2012.
- As of January 1, 2013, all of the changes above will "sunset," that is to say, will no longer apply to gifts made or estates of decedents dying on or after that date, unless Congress extends the changes or makes them permanent.

Planning Opportunities

- The $5 million gift tax exclusion and GST tax exemption, currently available only through 2012, present an **unprecedented opportunity** to make substantial (up to $10 million per couple) tax free transfers for the benefit of children, grandchildren and their descendants, particularly if both the gift and GST tax "exemptions" are used and are leveraged for maximum benefit.
- Making gifts now gets the exemptions working and moves future appreciation of gifted assets to the beneficiaries.
- The current very low interest rates applicable to various techniques, combined with depressed values, especially of closely held businesses and real estate, make the gift tax applicable exclusion amount go farther.
- Leveraging techniques to consider include qualified personal residence trusts, grantor retained annuity trusts, gifts and installment sales to grantor trusts and life insurance trusts.

Possible Traps

The large estate and gift tax applicable exclusion amount and the so-called portability of this amount may simplify planning, but **do not eliminate the need to plan.**

- The unparalleled increase of the applicable exclusion amount and the GST exemption to $5 million will affect existing estate plans that have formula provisions tied to those amounts if those provisions determine for whose benefit assets are held and how. **A review of one's documents and how this change in the law affects the estate plan is critical.**
- Taxes are only one component of many considerations in estate planning. Other considerations include planning for one's own incapacity and for minor and disabled beneficiaries, protection of spendthrift beneficiaries, carrying out both charitable and family goals and planning for the succession of a family business. With lower taxes, there will be more of an estate to be planned.
- Reporting to the IRS will be necessary on the death of the first spouse to take advantage of portability if it remains in effect, even for estates under $5 million.
- State estate and inheritance taxes also figure into estate planning for many individuals.
- The new provisions will expire as of January 1, 2013 without further Congressional action and approval by the President. **If Congress does not extend the new provisions**:
    - Portability would only be available if **both** spouses die before that date.

- The current opportunity to make large gifts and to leverage the gifts to pass a significant amount of wealth to children and their descendants without payment of current gift tax will be available only for a limited time.

Other Changes of Interest in Effect Through 2012

- Income tax free distributions of up to $100,000 from an IRA to charities are extended for 2010 and 2011. Any such distributions made on or before January 31, 2011 can be treated as made in 2010.
- An AMT "patch" was included that increases the exemptions for individuals and married taxpayers filing jointly to reduce the number of taxpayers subject to the tax.
- The income tax rates in effect for 2010 were extended, as were the 15% maximum rate on capital gains and qualified dividends.
- In 2011 only, the rates for an employee's portion of Social Security taxes and for self-employment taxes are both reduced by 2%.

Hahn Loeser's Estate Planning, Wealth Transfer and Preservation practice attorneys would be happy to review how your current plan may be affected by these changes in the tax law and to discuss the planning opportunities that may be available only during this year and next year. Visit hahnlaw.com or call 216.621.0150 for more details.