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To What Extent Should You Rely On Temporary Wealth Transfer Tax Changes Made By the 2010 Tax Act?

by Richard M. Morgan & Loraine M. DiSalvo

The Tax Relief, Unemployment Insurance, and Job Creation Act of 2010 (the "2010 Tax Act") was signed into law by President Obama on December 17, 2010. Among the 2010 Tax Act's many provisions were a number of items relating to the federal wealth transfer taxes, which are the estate tax, the gift tax, and the generation-skipping transfer ("GST") tax. Many of the wealth transfer tax provisions of the 2010 Tax Act merely continued changes made in 2001 and 2003 which were scheduled to end after December 31, 2010. However, the 2010 Tax Act also made several significant and surprising changes to the wealth transfer tax laws. Some of these changes applied retroactively to 2010, and others are currently scheduled to apply only during 2011 and 2012.

The biggest changes made by the 2010 Tax Act include: (1) an increase in the gift, estate, and GST tax exemptions to an historically high $5,000,000; (2) a reduction in the gift, estate, and GST tax to an historically low flat 35% rate; and (3) for married couples, the creation of rules which allow a surviving spouse to carry over any unused gift and estate tax (but not GST tax) exemption from his or her deceased spouse (commonly referred to as "portability" of the exemption).

At first glance, these three tax changes might make most married couples with an estate tax value (generally, net worth plus the full death benefit of any life insurance) of $10 million or less think that they don't need to do any significant estate planning, and that they would be fine with very simple Wills. However, for most married couples, there are still great benefits to be realized from more complex estate planning techniques, and relying on the changes made by the 2010 Tax Act may be a mistake. This newsletter is intended to discuss the 2010 Tax Act, the changes it made to the federal wealth transfer tax laws, and why it may not make sense for many people to rely on these changes when planning their estates.

I. Planning In Light of $5,000,000 Exemptions & 35% Tax Rate.

There is one major flaw which affects the increased, $5,000,000, exemptions for the gift, estate, and GST taxes and the reduced, 35%, rates for those taxes: these changes are temporary. The 2010 Tax Act's changes are only scheduled to remain in effect through December 31, 2012. As of

January 1, 2013, the laws which existed prior to the 2001 tax act are scheduled to return.[1]

Estate planning by its very nature is normally long term planning, since it deals with events which may not happen for many years. Estate planning also deals with issues most people don't want to have to think about too often. You simply cannot rely on rules which are in effect for only two years. There are some techniques which may allow you to realize some benefits under the temporary rules, but in order to be absolutely certain that all of the benefits are realized, you may need to die while they are still in effect (i.e., before 2013). In addition, the benefits offered by the portability of the gift and estate tax exemptions may, for many people, be outweighed by the benefits available through the continued use of more traditional estate tax planning techniques.

A. Who May Need or Want to Make Estate Planning Changes In Light of the 2010 Tax Act? Most of our clients likely will not need or want to make any significant changes based on the 2010 Tax Act's increased exemptions and tax rate reductions. However, those who fall into one of the situations described below may want to consider making some modifications to their estate plans.

1. Plans Where A Tax Exemption Amount Was Used to Determine the Amounts Passing to Different Beneficiaries. If your estate plan uses the estate tax exemption amount and/or the GST tax exemption amount to determine how your assets are divided among different classes of beneficiaries, then you should likely reconsider your estate plan based on the increased exemption amounts. As an example, if your estate plan calls for the distribution to your grandchildren of the maximum amount which can be covered by your GST tax exemption, and your spouse and children will not receive any share of those assets, then you should reconsider your estate plan as soon as possible. As another example, if your estate plan calls for your children to receive the maximum amount which can be covered by your estate tax exemption, and your spouse to receive only the excess assets, you should review your estate plan as soon as possible.

2. Plans Which Call For Outright Distributions to Beneficiaries. If your estate plan calls for assets to be distributed outright to some or all of your beneficiaries, you may want to reconsider the use of trusts, since the increased exemption amounts may result in more assets passing to the beneficiaries under your estate plan, and since trusts can help protect the assets those beneficiaries will receive. Having assets pass to a beneficiary in trust, rather than outright, can help protect the assets from the beneficiary's creditors, can help protect family assets from passing to a

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[1] Prior to the changes made in 2001, the gift and estate tax exemptions were $1,000,000, the GST tax exemption was a moving target (it was being adjusted for inflation, and was expected to be $1,340,000 for 2011 if the 2010 Tax Act had not been enacted), the gift and estate tax rates were as high as 60% (bracketed, but with a 55% top marginal rate and a 5% surcharge for estates above $10,000,000 which was designed to wipe out the effects of the lower brackets), and the GST tax rate was a flat 55%.

surviving spouse's new husband or wife, or provide protection from a beneficiary's ex-husband or ex-wife in case of a divorce. Using a third party Trustee can also help protect the assets from the beneficiary's imprudent investment or spending habits. Even if your plan already calls for the use of trusts for beneficiaries, you may want to consider using a corporate trustee rather than a family member or friend, if the increased exemptions could add a significant amount to the assets passing to the trusts.

B. For Those Who Are Inclined to Make Lifetime Gifts, 2011 and 2012 Offer Incredible Opportunities. Under the 2001 tax law changes, the gift tax exemption remained at $1,000,000 even while the estate tax and GST tax exemptions increased to $3,500,000. However, under the 2010 Tax Act, the gift tax exemption has been made equal to the $5,000,000 estate and GST tax exemptions for 2011 and 2012, and the gift tax rate has been lowered to the historically low rate of 35% for those same years. This massive increase in the gift tax exemption and decrease in the gift tax rate present unprecedented, if temporary, opportunities for those who have both the assets to give and the desire to give them away during their lifetimes - we believe these years will truly be the Golden Gifting Years. Our February 2011 newsletter will discuss these opportunities in more detail.

C. Those Who Live or Own Property In States Which Have Their Own Estate or Inheritance Taxes May Need to Update Their Plans to Avoid State Tax Problems As A Result of the Changes In Federal Law. For those people who either live in or own property in states which have their own estate or inheritance taxes, these state tax issues may become more of a concern due to the increased federal exemptions (Georgia is not one of these states). State taxes may still apply even when the federal estate tax would not, as many states set their exemptions considerably lower than the federal exemption. With proper planning, you may be able to avoid or minimize these state taxes.

II. For Married Couples - Planning In Light of the New Portability of the First Spouse's Gift and Estate Tax Exemption. Under the rules in effect before the 2010 Tax Act, each person was given an exemption from federal gift and estate taxes. However, the exemptions were not transferrable, and one spouse could not automatically use the other spouse's exemptions. In order for one spouse to use the other spouse's gift tax exemption, the spouses would have to file gift tax returns for any year in which a gift was made, and make an election to "gift-split." The surviving spouse could not make this election for gifts made after the first spouse's death. In addition, in order to preserve the benefits of the estate tax exemption of the first spouse to die, the couple would have to include special trust planning in their estate planning documents (commonly referred to as a "credit shelter" trust), and they had to ensure that they each individually owned enough assets to allow the special trust to be fully funded at the first spouse's death.

The 2010 Tax Act contains provisions which are intended to help reduce the need for married

couples to undertake special planning in order to preserve the benefits of both spouses' gift and estate tax exemptions. These provisions are designed to effectively make the estate and gift tax exemptions portable between spouses. However, while Congress' intent was good, the rules are far from perfect. Before deciding to rely on these portability provisions, you should consider the following issues:

A. The Portability Rules Only Apply to 2011 and 2012. Currently, in order for you to truly ensure that you receive the benefits of portability, both spouses will need to die before the end of 2012. This is because the 2010 Tax Act is currently set to vanish, as if it never existed, at the end of December 31, 2012. In order for the portability provisions to be effective after December 31, 2012, they will need to be either extended before January 1, 2013, or given "grandfathered" protection for those who had spouses dying during 2011 and 2012. This means that you will be at the mercy of Congress.

B. Portability Requires That An Estate Tax Return Be Filed At The First Spouse's Death, Even If No Estate Tax Is Due and the Estate Is Under the Exemption. The portability rules require that the Executor of the first spouse's estate file an estate tax return, in order to show the unused portion of the first spouse's gift and estate tax exemptions. The Executor also has to make the appropriate election on that estate tax return. This means that an estate tax return will be needed even though no estate tax will be payable and even though the estate tax rules might not otherwise require one to be filed. Preparing and filing an estate tax return is not a simple or inexpensive process. In addition, elections which have to be made on estate tax returns are often not made correctly, so it will be critical that the Executor of the first spouse's estate hire an knowledgeable and experienced preparer. Finally, if the estate tax return is not filed because the Executor and the surviving spouse decide that it is unlikely the first spouse's exemption will ever be needed, and it later turns out that it would have been beneficial to make the election (the surviving spouse wins a lawsuit, wins the lottery, marries well, gets a great new job, buys a bigger life insurance policy, etc.), it will be too late.

C. The Deceased Spouse's Exemption Will Not Increase After His or Her Death. Traditional "credit shelter" trust planning not only allows you to shelter the first spouse's exemption amount from estate tax at either spouse's death, it also allows you to shelter any appreciation on the assets held in the trust which occurs during the surviving spouse's lifetime. If the surviving spouse receives all of the first spouse's assets outright, however, the appreciation on those assets will be fully includible in the surviving spouse's estate, but the first spouse's exemption will remain fixed at the value it had at the first spouse's death. In other words, while the portability election allows the use of a frozen exemption figure, the use of the credit shelter trust allows you to shelter both the initial value of the first spouse's exemption, plus all of the appreciation on the sheltered assets during the surviving spouse's lifetime.

D. The Credit Shelter Trust Can Help Provide Its Beneficiaries With Protection From Their Creditors. Proper drafting can allow the assets which are placed in a "credit shelter" trust at the first spouse's death to be effectively made exempt from the claims of the beneficiaries' creditors. This protection can be very valuable, since you never know what curve balls life will throw. If the first spouse simply transfers all of his or her assets to the surviving spouse outright, which will likely be the technique used by those who decide to rely on portability, the first spouse's assets will have no additional protection, and will be fully subject to the surviving spouse's potential creditors.

E. The Credit Shelter Trust Helps Protect Assets In the Event the Surviving Spouse Remarries. If the first spouse uses a credit shelter trust for the surviving spouse's benefit, rather than simply leaving all of his or her assets outright to the surviving spouse, the credit shelter trust can help ensure that the surviving spouse is able to use and enjoy the assets, but that assets which remain in the trust at the surviving spouse's death actually pass to the first spouse's children (or other intended beneficiaries), not to the surviving spouse's new husband, wife, stepchildren, or children. The credit shelter trust, if drafted appropriately, can also help protect the interests of other beneficiaries from their own spouses, in the event a beneficiary gets divorced.

F. The Credit Shelter Trust Can Allow the First Spouse's GST Tax Exemption to Be Preserved. Only the first spouse's remaining estate and gift tax exemptions can be transferred to the surviving spouse under the portability rules, not the first spouse's unused GST tax exemption. Having the ability to use both spouses' GST tax exemptions can be very important from a tax perspective. However, and of more importance to many of our clients, using both spouses' GST tax exemptions can also be helpful in allowing you to shelter more assets from your children's or other desired beneficiaries' creditors and potential ex-spouses.

G. The Credit Shelter Trust May Allow You to Benefit From the Exemptions of More Than One Former Spouse. Under the complex rules which allow portability of the estate tax exemption, the actual exemption available to a surviving spouse is the unused exemption of his or her "last deceased spouse." That means that, if a surviving spouse's first spouse died and left her all of their $4,000,000 in assets outright, plus the full $5,000,000 worth of unused estate tax exemption; she remarries, and her second spouse also predeceases her and leaves behind only $100,000 of unused estate tax exemption; the surviving spouse will only be able to use the second spouse's remaining $100,000 estate tax exemption at her death, instead of her first spouse's remaining $5,000,000 estate tax exemption. This holds true even though the first spouse's $4,000,000 of assets are still includible in the surviving spouse's estate if she still owns them at her own death. If the first spouse had placed the $4,000,000 of assets into a credit shelter trust for the surviving spouse's benefit, rather than leaving them to her outright, she could have still used and enjoyed them during her lifetime. However, at her death, the remaining credit shelter trust assets would not be included in her own estate for estate tax purposes. In addition, if the second spouse's

executor made a portability election, the surviving spouse could still use his remaining $100,000 of unused estate tax exemption. In short, using a credit shelter trust still best helps prevent the waste of the first spouse's estate tax exemption. In addition, "credit shelter" trust planning can allow the surviving spouse the freedom to remarry or not remarry without having to consider the possible negative (or positive) transfer tax effects of the portability rules.

H. Using A Credit Shelter Trust Helps Limit the Length of Time In Which The IRS Can Audit the First Spouse's Estate Tax Return. Normally, if an estate tax return is filed properly, the statute of limitations will normally run out and prevent future IRS scrutiny after several years. However, if the first spouse's executor files the required estate tax return and makes the portability election, the statute of limitations remains open until after the surviving spouse's death. This is intended to allow the IRS only to confirm that the correct amount of exemption is being used by the surviving spouse, and it is not supposed to allow them free license to question everything on the first spouse's estate tax return. It does decrease the level of certainty which would otherwise be available after an estate tax return is filed, however, and potentially imposes additional record keeping requirements on the surviving spouse and his or her executor.

I. Portability Is Not Available For Non-U.S. Citizens. If either spouse is not a US citizen, the portability election is not available.

J. Potential Negative Effects From Using Credit Shelter Trust Planning Instead of Relying On Portability:

1. You will not be able to receive an income tax basis "step up" on the trust's assets at the surviving spouse's death. Because assets held by a credit shelter trust are not included in the surviving spouse's estate, they are not subject to the rules which would allow a "step up" in basis on appreciated assets at the surviving spouse's death.

2. If the credit shelter trust's assets decrease in value between the first and surviving spouse's deaths, the first spouse's estate tax exemption may effectively be partially wasted. If the credit shelter trust's assets decrease in value, the exemption which was used to cover the original asset value at the first spouse's death will be lost. If the surviving spouse had instead been given the ability to use the first spouse's remaining unused estate tax exemption and outright ownership of the first spouse's assets, the first spouse's estate tax exemption could still be used to cover other assets held by the surviving spouse at his or her death. Of course, this assumes that "portability" is either continued or "grandfathered" after 2012.

3. State estate or inheritance taxes may apply at the first spouse's death if a credit shelter trust is funded with the first spouse's full federal estate tax exemption amount. If you live in, own real estate in, or are for any other reason subject to the laws of a state which

imposes its own estate or inheritance tax, then fully funding a "credit shelter" trust at the first spouse's death may cause a state tax to become payable at the first spouse's death. However, there may be other estate planning techniques which can be used to avoid or minimize any such state level taxes.

The bottom line on portability is that, while the rules were well-intentioned, most people will still be better off continuing to use more traditional, "credit shelter"trust based planning. However, please note that, even for those who continue to use traditional credit shelter trusts, portability does offer the potential benefit of allowing the surviving spouse to use the first spouse's unused estate tax exemption if the first spouse's assets are not enough to fully use his or her estate tax exemption on the credit shelter trust.

If you have any questions about how the issues discussed in this article may affect you or your family, please contact us at (678) 720-0750 or sollila@morgandisalvo.com to schedule an appointment to speak with either Richard Morgan or Loraine DiSalvo. We look forward to helping you through the continued tax confusion.