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RETURN OF THE FEDERAL ESTATE TAX: NOW WHAT?

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After a year filled with confusion for taxpayers and tax practitioners, Congress has finally acted. The federal estate tax is back, along with its companion, the generation-skipping transfer ("GST") tax. Although proponents of permanent estate tax repeal are sorely disappointed, there is a silver lining. This new, historic legislation answers a number of questions, eliminates some problems caused by the temporary repeal, and creates some major planning opportunities – although perhaps only for the next two years.

This alert is not an exhaustive summary of the new Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act"). Nor does this alert cover issues involving estates of decedents who died during 2010 (although we would be happy to discuss those special aspects of the Act if you have an interest in such an estate). Instead, this alert focuses on the Act's impact on your lifetime gift and estate planning — both for now and during (at least) the next two years.

The Basics

As of January 1, 2011, the federal estate, gift, and GST tax will be imposed at a rate of 35%, with a $5,000,000 exemption ($10,000,000 for a married couple under the "portability" rule discussed below). The exemption is scheduled to be indexed for inflation (in increments of $10,000) after 2011. The pre-2010 "basis step-up" rule returns for 2011, eliminating both built-in capital gains and administrative nightmares for decedents' estates.

These rules have created unprecedented planning opportunities for many taxpayers.

Gift and Estate Tax "Reunification."

Perhaps the most exciting aspect of the Act is the increase in the exemption for lifetime gifts from $1,000,000 to $5,000,000 per donor for 2011. Although prior lifetime gifts count toward that exemption, for many taxpayers this rule permits tax-free gifts of up to $5,000,000 (up to $10,000,000 for many couples) during 2011 or 2012. If you have made prior gifts that resulted in a gift tax, the additional exemption may be somewhat less.

In most cases, this change eliminates the need to make 2010 year-end taxable gifts, since waiting until 2011 allows a donor to exploit the additional exemption. A donor making a larger gift can defer the gift tax by an extra year.

Individuals and families who are willing and able to engage in substantial noncharitable gifting should consult us as soon as possible in the new year, since the increased exemptions create an unprecedented planning opportunity. If lifetime gifts are properly structured, it is possible to increase the value of the new gift exemptions exponentially over time, resulting in massive tax savings.

"Portability" of Estate Tax Exemption.

If an individual who dies after 2010 leaves any of his or her estate tax exemption unused, the decedent's surviving spouse will be able to add the unused exemption amount to his or her own exemption amount.

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Example: Husband and Wife, who are both U.S. citizens, own $2,000,000 of assets jointly with rights of survivorship. Husband dies, after which Wife owns the entire $2,000,000 outright. Under the pre-Act tax law, Husband's estate tax exemption was wasted, since outright bequests to Wife escape estate tax regardless of the amount of the exemption. However, under the Act, Wife "inherits" Husband's entire $5,000,000 estate tax exemption (if her executor makes the appropriate election), so that unless her assets exceed $10,000,000 in value at the time of her death (or she remarries, in which case special rules apply), no federal estate tax will be due at her death.

A "portable" estate tax exemption is a welcome development for many married couples. In some situations, portability may make the most sense because assets owned outright by the surviving spouse may achieve a basis step-up at the surviving spouse's death. However, portability is neither a panacea nor a substitute for estate planning. In addition to the substantial nontax benefits associated with trusts (including asset management and asset protection), opting for trust planning in lieu of portability can produce several tax benefits.

The deceased spouse's unused estate tax exemption is effectively "frozen" under the portability rule. On the other hand, if a deceased spouse has used the exemption by creating a "credit shelter" trust for the surviving spouse, any appreciation in the trust's assets during the survivor's life will escape estate tax at the survivor's death. (However, depreciation or depletion of such a trust's assets effectively reduces the tax savings.)

Portability does not apply to the GST exemption. Thus, for families wishing to ensure tax savings over multiple generations, proper trust planning remains an essential component of the estate plan.

Portability also does not apply to any state death tax exemptions. Thus, for residents of New York, New Jersey, and other states that impose an estate tax, trusts typically remain necessary to achieve full state death tax benefits.

In sum, portability merely adds another potential option in structuring a couple's estate plan. Trusts will remain appropriate in many situations, so preserving flexibility will be key for many couples.

Return of the GST Tax; Increased GST Exemption.

The return of the GST tax answers many of the unresolved questions from 2010. 2010 lifetime gifts in trust are not "grandfathered," so it is not possible to achieve perpetual tax-free status for an unlimited amount of gifts. However, the $5,000,000 GST exemption is available to shelter 2010 gifts. Moreover, 2010 "direct skips" — gifts to, or in trust for grandchildren or more remote descendants (without any intervening interests of "nonskip" persons such as the donor's spouse or children) avoid the GST tax altogether, without any need to use GST exemption. Unfortunately, that result was not clearly established before the Act's passage, leaving a very narrow window to make such gifts. It may be possible to capture this "direct skip" benefit at the last minute, so if you are inclined to make gifts to grandchildren or other "skip persons," please contact your advisor immediately.

As with the lifetime gift exemption, a $5,000,000 per donor GST exemption should create some extremely valuable planning opportunities during the next two years. In many cases, you can use your GST exemption to shelter your family's assets from estate, gift, and GST taxes — not just at your children's deaths, but forever. Thus, properly exploiting this dramatic GST exemption increase will allow many families to achieve long-term tax savings of many millions of dollars, while shifting great wealth to multigenerational "family banks."

Unfortunately, the Act's two-year life span creates continuing uncertainty as to the effect of the exemption after 2012, so generation-skipping gifts will need to be carefully structured. Another point to bear in mind is the Act's preservation of the GST "automatic allocation" rule, which means that many people are unknowingly wasting their GST exemptions by making gifts to seemingly non-dynastic trusts. A careful review of your gifting and gift tax return history will allow you to plan for the most effective use of this extremely valuable tax exemption.

No Limits on Classic Planning Techniques.

The Obama Administration's initial proposal on estate taxes and several earlier bills in Congress had included limits on various estate planning

techniques, including grantor retained annuity trusts (GRATs) and family limited partnerships. Additional restrictions (including limits on "Crummey" trusts) have been rumored for many years. Fortunately, none of those techniques have been affected by the Act.

It remains possible that Congress will restrict or eliminate various estate planning techniques as part of a larger tax reform plan. Given the continued low-interest rate environment, GRATs remain an especially attractive planning vehicle, so you may wish to consider implementing one or more GRATs in the near term.

Effect on State Death Taxes.

State estate and inheritance taxes remain deductible for federal tax purposes. However, the lower 35% federal estate tax rate effectively increases the cost of dying as a domiciliary of New York, New Jersey, or other "death tax state." To the extent you are considering severing ties with one of those states and establishing domicile in a state that does not impose death taxes (e.g., Florida, New Hampshire, Virginia), you now have a somewhat greater tax incentive to do so.

Stay Tuned.

The Act is scheduled to "sunset" after 2012. Thus, unless Congress acts again within the next two years, the provisions of pre-2001 estate, gift, and GST tax law will return.

The political tumult we have seen in the estate, gift, and GST tax world over the past decade shows no signs of abating. Our best recommendations: act timely to take advantage of short-lived planning opportunities — and otherwise be ready for anything.

To learn more about the Act and its implications for your planning, please contact one of the following Lowenstein Sandler attorneys.

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