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Summary of Wealth Transfer Tax Provisions in 2010 Tax Legislation

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Dear Clients and Friends:

On December 16, 2010, the House passed and sent to the President for signature the "The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" ("The 2010 Act"). The 2010 Act affects both federal income and estate tax provisions. We will limit our discussion to a brief summary of the wealth transfer tax provisions

New Exemption Amount and Rate. The 2010 Act sets the gift, estate and GST exemption at $5 million per person and $10 million per couple. An estate, gift, and generation-skipping transfer tax rate of 35% will apply for transfers in excess of the exemption amount that are made in years 2011 and 2012, and for the estates of decedents who die in those two years. Legislative changes to wealth transfer taxes were enacted in 2001, and were scheduled to expire at the end of 2010. Those changes are given a two year reprieve. Absent further legislation, the changes made by the 2001 legislation (both good and bad) still expire at the end of 2012.

The exemption amount is indexed in $10,000 increments beginning in 2012. Given recent rates of inflation, however, such adjustments may not be automatic.

Portability of Unused Exemption. Under prior law, couples had to utilize elaborate estate tax planning to claim the combined estate tax exemption available to a married couple ($10 million under the 2010 Act). Typical planning involved the funding of a "Bypass" or "Credit Shelter" trust on the death of the predeceased

spouse. A married couple often had to retitle assets to facilitate the funding of that trust regardless of which spouse died first.

The new legislation allows the executor of a deceased spouse's estate to transfer any "deceased spouse unused exemption amount" ("DSUEA") to the surviving spouse. The surviving spouse may apply the unused exemption amount to shelter assets subject to tax after the surviving spouse's death without complex trust planning. The portability benefits will only be available for the estates of decedents dying after 2010. The benefit of a DSUEA was not made retroactive to January 1, 2010.

Unfortunately, the new portability paradigm continues to make this decision making complex. Assets held in a traditional Bypass Trust on the death of the predeceased spouse could appreciate without limit and not be subject to tax in the surviving spouse's estate. If the couple chooses the cheaper "I love you" plan, leaving all of the predeceased spouse's property to the surviving spouse outright and expecting the DSUEA to "soak up" property up to the exemption amount, then portability might protect the assets up to the amount of the DSUEA. The amount of the DSUEA transferred to the surviving spouse, however, will not qualify for the inflation adjustment. Remarriage may cut off the right to use the prior spouse's DSUEA. Surviving spouses who remarry may need to confirm the remaining DSUEA and negotiate its applicability in connection with a prenuptial agreement.

Assets bequeathed to a surviving spouse and protected by the new "portable" estate tax exclusion will increase in value as a result of inflation, but the portable portion of the predeceased spouse's exclusion appears to be frozen at the date of death value, without the benefit of inflation indexing. This gap provides an important rationale for continuing to advocate for creating and funding a Bypass Trust on the first death.

The surviving spouse must decide whether to fund a Bypass Trust without the benefit of hindsight. To make the optimal decision, the surviving spouse must evaluate with counsel which assets may be used to fund the Bypass Trust, the appreciation potential of those assets, the life expectancy of the surviving spouse, the likelihood that the surviving spouse will remarry and leave a second surviving spouse, and the inflation increase in the estate tax exemption allowable under applicable federal law.

Portability will create the odd circumstance that a surviving spouse may be required to file an estate tax return to preserve the DSUEA, even though the estate is not taxable. Ironically, a provision intended to reduce the cost of transferring wealth may increase the administration costs upon the death of a spouse. Surviving spouses or executors who make a conscious decision not to file a return, knowingly sacrificing an otherwise available DSUEA in order to avoid a potential audit, may expose the estate assets to potential re-assessment for an extended period. The limitations period on assessment does not begin to run until a return is filed with the tax authorities.

Transferring all assets to the surviving spouse and relying upon the DSUEA to eliminate the estate tax after the survivor's death may have an incremental benefit for federal income tax purposes. Assets included in the surviving spouse's estate would receive an adjustment ("step-up") in income tax basis on the surviving spouse's death. That basis adjustment would eliminate capital gains tax on appreciation through the surviving spouse's death. Assets allocated to a Bypass Trust would not qualify for this adjustment.

Portability is not applicable to the GST tax. Those estates wishing to take advantage of the GST exemption of the predeceased spouse must establish a trust in any event.

Reunification. Prior to 2001, estate and gift taxes were unified under a single graduated rate schedule. A single lifetime exemption applied to both inter vivos gifts and to testamentary bequests. Legislation enacted in 2001 decoupled these systems. The 2010 Act reunifies the estate and gift tax systems with a common $5 million exemption. This provision in the 2010 Act is effective for gifts made after December 31, 2010.

Valuation Discounts. The 2010 Act includes no restrictions on discount planning. Existing law that allows valuation adjustments to determine fair market value for estate and gift tax purposes remains unchanged. These adjustments typically apply to closely held stock, limited partnership interests and other restricted assets. When valuation adjustments are combined with the $5 million gift tax exemption in 2011, a donor may transfer substantial wealth. A two year time horizon is assured for the $5 million exemption; further legislative changes may occur thereafter. Clients should not overlook this opportunity to plan for transfers to younger generations.

Grantor Retained Annuity Trusts (GRATs). GRATs had been slated for substantial restrictions, tantamount to repealing the tax benefits from creating and funding those trusts. The 2010 Act includes no restrictions on GRATs.

Qualified Personal Residence Trusts ("QPRTs"). The higher exemption amounts for years 2011 and 2012 diminish the transfer tax advantages of QPRTs for many clients who previously took advantage of this planning approach. QPRTs were especially useful to clients who had moderate wealth potentially subject to estate tax with a residence that was a significant asset, but who did not have a sufficiently large estate that made cash gifts or other gifting approaches palatable. For many of these clients, creating and funding QPRTS may not be advantageous, at least until 2012. Nevertheless, clients whose homes are so valuable that the previous exemption amounts made QPRTs impractical may consider re-evaluating this approach.

Formula Clauses and Bequests. The changes in the 2010 Act make it essential for clients to review all formula clauses keyed to estate tax exemption amounts. This review might include not only the obvious ones such as the funding clause for a Bypass Trust, but also estate related clauses in prenuptial and buyout agreements. Since the 2010 Act only extends the expiring provisions of the 2001 legislation for two years,

formula clauses may need to be modified to included explanatory provisions, caps and floors, and other safeguards to deal with the unknowns of 2013 and beyond. Married couples who assume that their combined marital estates will never exceed $10 million may be unwilling to pursue such drafting complexity.

2010 Transition and Election Concerning Carryover Basis. Executors of estates of decedents who died in 2010 may elect to apply the $5 Million estate tax exemption and step up in income tax basis provided in the new law. This retroactive tax benefit may provide considerable simplification for many 2010 estates. In addition, making the election would allow tax practitioners to address compliance issues with a known body of law. Preliminary indications are that in most if not all instances the carryover basis regime will be preferable for all estates over $5 million, and the provisions of the 2010 Act preferable for estates under that amount.

Deadlines for 2010. Recognizing that the estate tax rollercoaster has made transfer tax planning difficult or worse, the 2010 Act provides additional time for executors of 2010 estates to make certain elections and actions. Executors whose estates might benefit from these extensions should withhold distributions pending clarification of the law. For 2010 decedents **who died prior to the date of enactment**, the following deadlines are extended until nine months after the date of enactment: filing an estate tax return; filing a large estate (basis allocation) return; paying the estate tax; and making qualified disclaimers. A qualified disclaimer must nonetheless comply with applicable state law, so that local statutes may also need to be modified to accommodate an extended deadline. California taxpayers should not expect such remedial assistance from Sacramento, and should execute any disclaimers within nine months of the date of death.

Gift and GST Tax Considerations for 2010. The 2010 Act confirms the 35% gift tax rate that applied in 2010, and sets the same estate tax rate for 2010. The $5 million gift tax exclusion only applies after 2010. The prior law $1 Million gift tax lifetime exclusion remains in effect in 2010.

The statutory language of the 2010 Act appears to reinstate a $5 million GST exemption and a 0% tax rate as of *January 1, 2010*. This retroactive application was intended to ease the burden on estates of decedents dying in 2010. Nevertheless, a close reading of the language appears to permit allocation of the new $5 million GST exemption to gifts to a GST trust funded in 2010. If the Treasury accepts this analysis, clients will need to re-evaluate all GST transfers in 2010, analyze the terms of any generation-skipping trusts, and decide what reporting positions to take.

A contrary analysis of these provisions concludes that no GST tax would be assessed on the funding of a trust for grandchildren in 2010. Later distributions from those trusts to a grandchild beneficiary would also not be subject to GST tax. Later distributions to descendants of those grandchildren (e.g. a great-grandchild) would, however, be subject to that tax. A gift to such a direct skip trust in 2010 would be subject to automatic allocation unless the taxpayer *elects out* on a *timely filed* gift tax return in April 2011. If the client wants the 0%

GST tax rate for transfers to grandchildren without using the available GST tax exemption, the client must file a timely 2010 gift tax return and make a proper election.

Charitable Gifts from IRAs. The exclusion from income of IRA distributions for charitable purposes is extended through 2011, up to a maximum of $100,000 per taxpayer each year. A special rule allows taxpayers to treat such distributions made in January 2011 as if made on December 31, 2010, qualifying for the exclusion on a 2010 return.

The New Estate Tax Numbers. If the $1 million estate tax exemption had been reinstated in 2011, 2,886,200 Americans would have been affected. Approximately 36,300 Americans in 2009 were classified as ultra high net worth, with estates of $30 million or more. In 2001, only 338,400 American families with a net worth of more than $10 million. Only 16,000 estate tax returns were filed in 2009 when the exclusion was $3.5 million. Under the 2010 Act and with portability, a very modest number of returns, representing an insignificant number of decedent's estates, will be filed.

CONCLUSION

Estate planning appears about to experience a dramatic change. Survivorship life insurance policy sales, insurance trusts, and more sophisticated techniques will have less tax utility than under prior law. For taxpayers the 2010 Act provides less tax but not less complexity, because 2013 could bring another sea change in the law. Please feel free to call with any questions you may have.

Very truly yours,

JOHN A. HARTOG, INC.