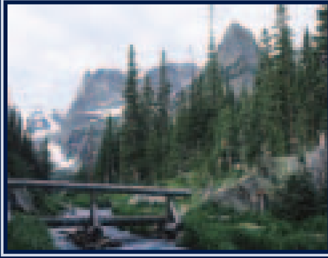

WADE ASH

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NEWSLETTER

January 2011

TAX RELIEF PLAN OF 2010 ENACTED!

We are as surprised as our clients that Congress and the President reached agreement on a new tax bill and enacted the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 on December 17, 2010 (the "Act"). Unfortunately, the provisions in the Act sunset at the end of 2012, so we may be right back in the same uncertainty relatively quickly, but at least we have rules to guide us for 2010 through 2012.

Brief Summary:

- $5 million estate tax exemption 2010 through 2012 and full step up in basis
- $5 million gift tax exemption 2011 and 2012
- $5 million generation-skipping transfer (GST) tax exemption 2010 through 2012
- 35% estate, gift and GST tax rate, but 0% GST tax rate in 2010
- 2010 estates can elect to be taxed with no estate tax and modified carryover basis
- portability of unused deceased spouse's exemption 2011 and 2012
- extension of lower income tax rates generally through 2012

EFFECT ON YOUR ESTATE PLAN

You should review your estate plan documents and consider how the $5 million estate and GST tax exemptions will affect any formula provisions, such as a division between a Family Trust and Marital Trust. Also, consider the effect of "portability" of the exemption that could double the surviving spouse's estate (but not GST) tax exemption.

For those who want more details, read on:

2010 DECEDENTS' ESTATES

As we discussed in our 2010 newsletters, much confusion was caused by the state of the tax laws for estates of decedents dying in 2010. Congress did us a favor by simplifying required filings for smaller estates. Under the Act, the rules for 2010 decedents include the estate and generation-skipping transfer ("GST") tax system we have grown to know and love, including step up in basis for assets in the estate to fair market value on date of death, but with a $5 million exemption, and 35% tax rate. Therefore, for estates in 2010 less than $5 million in gross value, a U.S. Estate Tax Return (Form 706) is not required to be filed, and the estate and the beneficiaries will receive a new basis equal to fair market value on date of death. This greatly simplifies the tax rules for smaller estates. For estates that will have to file a Form 706 (gross estate more than $5 million and they do not elect out of this tax regime), the return will be due the later of 9 months after date of enactment or 9 months after date of death. Because the Act was signed by the President on December 17, 2010, the due date for most returns is September 19, 2011 (a Monday). The Act also extends the time period for making a qualified disclaimer to 9 months after date of enactment, so long as it would be permitted under state law.

Under the strange rules which were in effect only for 2010 (which we reviewed in prior newsletters), there was no federal estate tax and no GST tax, but also no step up in basis for assets included in the estate. Instead, a "carryover basis" applied so that the estate and beneficiaries would receive the decedent's basis in assets (not always easy to determine). The law provided a $1.3 million basis allocation (plus $3 million for assets passing to the spouse or a Qualified Terminable Interest Property Trust) that could increase basis for assets passing from the decedent. The basis allocation, even for small estates, had to be made on a return to be filed at the same time as the decedent's final 1040, and did not apply to assets that might have been included in an estate for tax purposes, but did not "pass from the decedent." One example of such an asset would be a Marital Trust created on the death of a predeceased spouse: for a surviving spouse dying in 2010, those assets could not receive any of the basis allocation even though they would have been included in the spouse's gross estate. More importantly for trusts created for descendants of a 2010 decedent, there was no GST exemption to allocate.

2010 DECEDENTS' ESTATES (CONT'D.)

Under the new Act, estates can elect to be taxed under the special 2010 rules by filing the basis allocation form 8939 by the due date of the decedent's final 1040, or April 15, 2011 unless extended. Larger estates will most likely want to elect to be taxed under the special 2010 rules instead of the new rules. The beneficiaries will then have a carryover basis, as increased by the available basis allocation, but the capital gain tax rate (15% until 2013) is lower than the estate tax rate of 35% that otherwise would apply. Part of the good news in the Act is that even for larger estates electing to be taxed under the special 2010 rules, there is a GST tax *with a 0% rate for 2010 only*, and $5 million of GST exemption to be allocated. Also, the automatic allocation rules again apply.

Estates that are close to the $5 million filing limit must run the numbers to determine which tax option is better for the beneficiaries. If the beneficiaries will be treated differently (spouse versus children, for example), the personal representative can have significant conflict of interest problems. It may be prudent to extend the filing date for the decedent's final 1040 to give the fiduciaries and their advisors more time to determine the best course of action. Formula provisions in a Will or trust might have extremely different results under a $5 million exemption versus "unlimited exemption" with no federal estate tax. The fiduciaries will need to carefully consider the decision to fund a Family Trust or Credit Shelter Trust with $5 million and the remainder to a Marital Trust, or potentially 100% of the estate to the Family Trust with nothing to the Marital Trust. Court approval may be necessary or desirable to protect the fiduciaries facing such formula provisions.

Certain estates might decide to elect to be taxed under the special 2010 rules just to avoid having to file a Form 706 (or running the risk of having to file if valuations or lifetime planning transactions are audited in the future): those with risky lifetime transfers or gift valuations that are subject to different interpretations, estates with large discounts in limited partnerships or other business entities, transactions involving sales to intentionally defective grantor trusts, risky deductions, or deductions for contingent claims that under the estate tax regulations cannot be deducted until paid.

The Act extended the *deduction* for state death taxes, as opposed to returning to the old "state death tax credit" which means that Colorado still does not have any estate tax (at least until 2013).

2010 GIFTS

The gift tax exemption for 2010 is $1 million. It increases to $5 million in 2011. The gift tax rate is 35% for 2010 gifts and stays at that rate through 2012.

Congress did not make any changes to the minimum term of a Grantor Retained Annuity Trust (GRAT) which had been expected (a 10-year minimum term), so short-terms GRATs can still be created at this time. Congress also did not make any changes to minority discount rules for valuation of closely-held business interests.

2010 GST RULES

As mentioned above, there is a $5 million GST exemption for 2010, applicable both to gifts and decedents' estates. Therefore, there is a "transferor" for a 2010 decedent so that Dynasty Trusts in unlimited amount cannot be created. But the good news is there is a $5 million GST exemption, with all of the normal rules of automatic allocation, qualified severance, and requesting relief. This means that for 2010 contributions made to life insurance trusts or trusts for grandchildren, for example, there is GST exemption that can either be automatically allocated, or allocated on a U.S. Gift Tax Return (Form 709), so that those trusts will continue to be wholly exempt.

The special rule for GST transfers in 2010 is the *tax rate is 0%*. Therefore, some persons were willing to pay a gift tax of 35% to make large 2010 gifts to grandchildren in exchange for a zero GST tax. Many trustees also reviewed their Nonexempt Trusts to determine if GST distributions should be made (or could be made under the trust terms) in 2010 to take advantage of the zero tax rate.

Estates of 2010 decedents that elect out of the $5 million estate tax exemption tax regime still have a GST exemption of $5 million. Children of 2010 decedents might want to take advantage of the extended disclaimer period to disclaim and have assets pass to their children at a zero GST tax rate.

2011 AND 2012 ESTATE, GIFT AND GST RULES

Starting in January, 2011 and until December 31, 2012, the estate, gift and GST exemptions will all be the same with a unified $5 million exemption, and that amount will be indexed for inflation beginning in 2012, in $10,000 increments. The tax rate is 35% for gifts, estates and GST transfers in excess of the exemption. All of the usual rules still apply: step up in income tax basis, automatic allocation of GST exemption, and the more favorable rules for installment payments of estate tax and conservation easements.

At this point, there is some uncertainty about the effect of a $5 million gift in 2011 on the estate of a 2013 decedent

2011 AND 2012 ESTATE, GIFT AND GST RULES (CONT'D.)

with possibly only a $1 million estate tax exemption at that time. The Code and regulations as they apply to this issue are confusing enough that commentators are not in agreement whether the $5 million gift stays "untaxed" or results in a tax in 2013. The exemption has not decreased at any time in the past, so the rules are not clear on how they would apply in that situation. We will try to keep you updated on that issue.

One significant change is the concept of *portability* of the estate tax exemption. This means that for a first spouse to die whose estate does not need to use the entire $5 million exemption, the excess can be used at the surviving spouse's later death. This concept may appear to render unnecessary the common planning that includes creating a Family Trust or Credit Shelter Trust upon the first death to preserve that spouse's exemption, but there are many reasons we still generally recommend such planning. First, portability of the unused exemption must be elected on a timely filed estate tax return for the first deceased spouse. Most smaller estates often do not file anything, and the survivors do not contact attorneys if all assets are titled jointly, and this filing requirement may often be missed. Second, the surviving spouse's total exemption cannot exceed twice the exemption in effect at that time. Therefore, if the first spouse died with an unused $5 million exemption (because all assets passed to the spouse), but the surviving spouse died with only a $1 million exemption, the survivor's exemption could only increase to $2 million. Finally, portability only applies to the *most recent* deceased spouse. If surviving spouse remarries, and that new spouse then dies and uses all of his or her exemption, no increase due to portability will be available for the estate of the surviving spouse.

We recommend that clients consider amending their Wills or revocable trusts to add a direction to the personal representative to file the return to make the portability election, and to protect the personal representative from liability for doing so. Making the election and doubling the exemption available to the surviving spouse could significantly affect the results of formula clauses in the surviving spouse's documents. There is *no portability of the GST exemption.*

ANNUAL EXCLUSION GIFTS

The gift tax annual exclusion is $13,000 for gifts in 2011. Do not forget to make those gifts early in the year if you need to reduce the size of your estate.

MISCELLANEOUS PROVISIONS

IRA Charitable Rollovers: The provision authorizing a taxpayer at least age 70 ½ to give up to $100,000 directly from an IRA to charity without having to recognize the distribution in income expired December 31, 2009. The Act extended it retroactively for 2010 and through 2011 (but not 2012 even though much of the Act applies to 2012). The distribution will also qualify for the taxpayer's Minimum Required Distribution for that year. There is a special election for a direct rollover made in January, 2011 to have it treated as having been made on December 31, 2010.

Conservation Easements: The enhanced deductions for conservation easements that expired December 31, 2009 are extended through 2011.

Capital Gains and Qualified Dividends, and Lower Individual Tax Rates: The 15% capital gains rate and 15% rate on qualified dividends were extended through 2012 (not just through 2011), and the lower individual tax rates were extended through 2012.

AMT Patch and Miscellaneous Tax Breaks: Many of the individual and business tax breaks that expired December 31, 2009 and the AMT exemption amounts were extended through 2011.

Payroll Tax: The Social Security tax on wages and self-employed individuals is reduced from 6.2% to 4.2% for 2011.

If you have any questions about the new tax Act, and how it may impact your estate plan, please do not hesitate to contact us.

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