

Advisories

Making the Most of the New Tax Law: Estate Planning and Wealth Transfer Strategies in 2011 and 2012

By G&S Private Client & Trust Group

February 2011

On December 17, 2010, after an extended period of uncertainty in estate, gift, and generation-skipping tax law, President Obama signed the Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 (the "Act") into law. In doing so, the government increased gift, estate and generation-skipping tax exemption amounts, reduced tax rates, and created one of most generous transfer tax regimes in U.S. history.

At least for the next two years.

Scheduled to expire after 2012, the Act is only a temporary fix to recent tax law debates. In 2013, the tax rules revert to those that were in effect before President Bush's 2001 tax cuts, featuring far less generous tax exemptions and much higher tax rates applicable to gifts, estates and generation-skipping transfers. It is impossible to predict whether the provisions of the Act will be extended, particularly in light of a looming election cycle. Absent extension, the Act provides a limited window to make use of certain estate planning and wealth transfer opportunities. Consequently, now is the time to consider asset transfers to children, grandchildren and other family members.

Lifetime Gifts

Perhaps the Act's most significant change is the increase in the gift tax exemption amount from \$1 million to \$5 million. Until the end of 2012, individuals may make lifetime transfers of up to \$5 million of assets (or an aggregate of \$10 million by a married couple) free of gift tax—and this is above and beyond the *annual* gift tax exclusion of \$13,000 that each person may use to make tax-free gifts to any other person. Once cumulative transfers exceed the exemption, the excess is subject to a maximum gift tax rate of 35% (reduced from 45%). In 2013, if the Act is not extended or made permanent, the exemption is scheduled to drop to only \$1 million and the top gift tax rate will rise to 55%.

Getting the Most Out of Your Gift. The combined high gift tax exemption and low gift tax rate creates a unique opportunity for individuals to transfer wealth out of their estates by making substantial gifts of cash or other property. To make the most of your gift tax exemption, consider the following techniques:

- Give assets with a low current value and a high possibility of future appreciation.

- Give assets with a current value that can be reduced by discounts reflecting the owner's lack of control and the assets' lack of marketability. For example, non-controlling closely-held stock and partnership interests often are valued using such valuation discounts.
- Forgive loans to children.
- Make larger than usual gifts to a life insurance trust. The trust will use the funds to pay premiums over time and you will not have the complexity of annually adding more funds to the trust. You'll be able to use your \$13,000 annual exclusion from gift tax to make other gifts to children and grandchildren.
- Consider making gifts to a trust for the benefit of children or grandchildren, thereby protecting the assets from the reach of their creditors and from potentially being lost in a divorce.
- For the largest estates, consider making gifts in excess of the available exemption and paying gift tax at the historically low rate of 35%.
- In addition, Massachusetts has an estate tax but not a gift tax, so making lifetime gifts may save significant state estate taxes.

It's not clear under the Act whether a donor who makes lifetime gifts in 2011 and 2012 using the larger gift tax exemption will be subsequently taxed on part or all of such gifts if there is a smaller estate tax exemption in effect at the time of the donor's death. Donors using the larger gift tax exemption must be aware of this possibility and should be satisfied that at least the income and appreciation on the transferred assets will escape gift and estate tax.

Generation Skipping Transfers

Congress created the generation-skipping transfer tax ("GST tax") so that transferred assets will incur a tax similar to a gift or estate tax at least once in each generation. The GST tax applies to lifetime gifts or death-time transfers that skip a generation (such as from a grandparent to a grandchild or to a trust for a grandchild), and is in addition to gift or estate tax. The GST tax also applies to a trust for the benefit a child at the time of the child's death, if the successor beneficiary is a grandchild. To make the GST tax palatable, each individual has a GST tax exemption that is separate from the gift and estate tax exemption. Under the Act, in 2011 and 2012 the amount of the GST tax exemption is increased to \$5 million while the GST tax rate is reduced to 35%. In 2013, if the Act is not extended or made permanent, the GST tax exemption will decrease to \$1 million (but adjusted for inflation since 2001) and the GST tax rate will increase to 55%.

Getting the Most Out of Generation Skipping. The combined high GST tax exemption and low GST tax rate creates a unique opportunity for individuals to transfer wealth directly to grandchildren or younger generations, or to trusts that benefit children, grandchildren and younger generations. The types of lifetime gifts and trusts described above with respect to making the most of the gift tax exemption are also effective with respect to making the most of the GST tax exemption. For example:

- Give assets with a low value currently and a high possibility of future appreciation to a trust for children and their descendants. Allocate both gift tax and GST tax exemptions so as to shelter the assets from taxes at the time of the transfer and for the duration of the trust. There is also no estate tax at the deaths of trust beneficiaries because the beneficiaries do not own the trust assets.

Transfers at Deaths in 2011 or 2012

In 2011 and 2012, the estate tax exemption amount is increased to \$5 million (reduced by any part of the gift tax exemption used during the decedent's lifetime), and the maximum estate tax rate on the portion of an estate exceeding the available exemption is reduced to 35%.

Effect on Current Estate Plans. For more than a generation, we have advised married couples that each spouse should hold assets in his or her separate name so that whichever spouse dies first will have an estate large enough to make use of his or her exemption from federal estate tax. We have further advised that a bequest in the amount of such exemption should pass to one or more trusts for the surviving spouse (and sometimes the children) so as to shelter such assets from estate tax using the deceased spouse's exemption, and prevent such assets from subsequently becoming part of the surviving spouse's taxable estate. As discussed below, we still think this is good advice, and it is worth noting that for the next two years there is an estate planning incentive for each spouse to have up to \$5 million of assets in his or her separate name in order to make full use of the expanded exemption.

Portability Between Spouses. Under the Act, the surviving spouse of an individual who dies in 2011 or 2012 may, for the first time ever, elect to "inherit" the deceased spouse's unused estate tax exemption and use it (in addition to his or her own exemption) at his or her subsequent death. Called "portability", this technique is helpful where the deceased spouse has insufficient assets in his or her separate name to fully use the exemption, or the deceased spouse does not have an estate plan that makes use of a trust to shelter the unused exemption. A benefit to portability is that more assets pass outright to the surviving spouse and are eligible for a step-up in income tax basis as part of the surviving spouse's taxable estate. (A "step-up" in income tax basis generally means that any capital gains tax upon the sale of an asset following a decedent's death will apply only to appreciation that occurred after the decedent's death, and not to appreciation that occurred during the decedent's lifetime.) However, the Act has just a two year lifespan and we simply don't know whether portability will be available in any subsequent year. For that reason alone, planning for use of the estate tax exemption at the first death can be preferable to planning for the option of portability. Additional benefits of continuing to plan for each spouse to own some assets, and for a deceased spouse's assets to pass to one or more trusts for the benefit of the surviving spouse, include:

- Ensuring that, after both spouses have died, trust assets benefit the couple's descendants and not any new spouse.

- Protecting assets from the claims of creditors of the surviving spouse and descendants (including claims that may arise in divorce).
- Appreciation on assets held in trust for the benefit of the surviving spouse will pass free of estate tax at the surviving spouse's death (which is not the case if the assets pass outright to the surviving spouse).
- Making full use of the deceased spouse's exemption from generation-skipping transfer tax. There is no portability of this exemption, which means that the deceased spouse's unused GST tax exemption can be lost if all assets pass outright to the surviving spouse.
- Same-sex spouses and unmarried domestic partners are precluded from electing into portability.

Income Tax Issues

The following are additional noteworthy income tax provisions found within the Act:

- ***Charitable Distributions from an IRA.*** In 2011 and 2012, an individual who is 70½ years of age or older may direct distribution of up to \$100,000 from an IRA to one or more public charities (but not a donor advised fund or private foundation). The amount directed will not be subject to federal or Massachusetts income tax.
- ***Step-Up in Basis on Decedent's Death.*** Property passing as a result of a decedent's death in 2011 or thereafter will receive a full step-up in income tax basis.

For questions about the information contained in this advisory, please contact your Goulston & Storrs attorney or any member of the Private Client & Trust Group.

This advisory should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own lawyer concerning your situation and any specific legal questions you may have.

Pursuant to IRS Circular 230, please be advised that, this communication is not intended to be, was not written to be and cannot be used by any taxpayer for the purpose of (i) avoiding penalties under U.S. federal tax law or (ii) promoting, marketing or recommending to another taxpayer any transaction or matter addressed herein.