

# PIERRO LAW GROUP<sup>LLC</sup>

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## 2010 TAX ACT -KEY ESTATE & GIFT TAX CHANGES-

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On December 17, 2010 President Obama signed the **Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010** (the Act). In addition to extending unemployment benefits and current income tax rates (Bush-era tax cuts), the 2010 Act significantly changes the federal estate tax, which impacts estate planning for many of our clients, and presents significant estate planning opportunities. This memorandum summarizes some of the Act's key changes and provides you with our observations about the Act's impact on estate planning.

### SUMMARY OF KEY ESTATE AND GIFT TAX PROVISIONS OF THE ACT

#### **Estate Tax**

Before the 2010 Act, prior law provided that there was no estate tax in 2010 and that the estate tax would be reinstated in 2011 with a \$1 million exemption amount and a maximum tax rate of 55%. The new law reinstates the estate tax for 2010 at a \$5 million exemption amount and a 35% maximum tax rate. For the next two years, 2011 and 2012, the exemption amount remains at \$5 million and the maximum tax rate stays at 35%. In 2013 the new law sunsets and the exemption amount returns to \$1 million and the maximum tax rate returns to 55%.

The Act also provides for "portability" between spouses for deaths after 2010, meaning that the unused exemption amount of a deceased spouse may be used by the surviving spouse, if both spouses die before 2013. Special limits apply to decedents with multiple predeceased spouses. To preserve the first deceased spouse's unused applicable exclusion amount, the executor for such spouse must file an estate tax return and make an election on such return, even if such an estate tax return would otherwise not be required.

#### **Gift Tax**

For gifts made in 2010 only, the gift tax exemption is \$1 million and maximum rate of 35%. For gifts made in 2011 and 2012, the Act increases the applicable exclusion amount to \$5 million at the maximum rate of 35%. In addition, the annual exclusion amount is \$13,000 per donee (married couples may continue to "split" their gift and may make combined gifts of \$26,000 to each donee). These changes provide an opportunity to move significant amounts of wealth free of estate and gift taxes. You must act quickly because in 2013 the gift tax exemption amount returns to \$1 million with a 55% maximum rate.

#### **Generation Skipping Transfer (GST) Tax**

The Act provides a \$5 million GST exemption amount for 2010 with a 0% tax rate for 2010 only. For transfers made to grandchildren and great-grandchildren after 2010, the GST tax is reinstated with a \$5 million exemption. For 2011 and 2012, the GST maximum tax rate is 35%. In 2013 the GST exemption amount

returns to \$1 million, indexed for inflation, and a maximum tax rate of 55%.

## PLANNING OPPORTUNITIES AND OBSERVATIONS UNDER THE ACT

Generally, the estate and gift tax provisions of the Act are very favorable to taxpayers because of the substantial increase in the applicable exclusion amount, to \$5 million, and the lower maximum estate and gift tax rate of 35%. Being able to make transfers of up to \$5 million (\$10 million per couple) without having to pay gift taxes allows for planning opportunities that, combined with leveraging strategies, can transfer huge amounts of wealth. Some of those planning opportunities include:

**Increased Applicable Exclusion Amount** - Being able to give up to \$5 million (\$10 million per couple) in a lifetime will allow many to make all of the lifetime transfers they want without any concerns about gift taxes.

**Leveraged Transfers to Trusts** - Making transfers to dynasty/ grantor trusts (under which the trust income is attributed to the donor) can allow substantial additional trust growth and drain away the donor's taxable estate. Because the trust does not pay the tax on trust income, the trust assets will grow faster. Plus, the donor, by continuing to pay the income tax, further reduces his or her estate. This technique works especially well for family businesses or assets that are expected to grow significantly in value over time.

**Gift Splitting** - If one spouse has most of the marital wealth, the couple can make the split gift election and take advantage of both spouses' gift exemptions of \$5 million.

**Life Insurance Transfers** - A very large amount of life insurance coverage can be purchased with gift tax exemptions of \$5 million (\$10 million for married couples). If structured properly, the insurance proceeds can pass free of probate, income and estate taxes to younger generations.

**Optional Retroactive Planning for 2010 Decedents** - The Act gives estates of decedents dying during 2010 the option to apply (1) the estate tax based on the new 35% top rate and \$5 million applicable exclusion amount, with stepped-up basis for inherited assets, or (2) no estate tax and modified carryover basis rules under prior law. Property with a *stepped-up basis* generally receives a basis equal to the property's fair market value on the date of the decedent's death. Under the modified *carryover basis* rules that applied during 2010 before the Act, estate property received a basis equal to the lesser of the decedent's basis at time the property was first acquired or the property's fair market value on the decedent's death.

Typically, smaller estates of less than \$5 million will be better off under the estate tax, allowing the estate to take full advantage of the \$5 million exemption, and giving the heirs a full fair market value basis in the inherited assets. Larger estates, however, may find it advantageous to opt out of the estate tax and to take the lower carryover basis required for inherited assets. The heirs would be subject to future capital gains tax on appreciation earned during the decedent's lifetime in excess of their carryover basis as adjusted, but the capital gains tax rate of 15% is substantially less than the estate tax rate of 35%. Determining which estate tax option to elect will be dependent on the facts and circumstances of each estate. Executors have an additional 9 months after the enactment date to decide, file an estate tax return, pay taxes and make disclaimers.

### Temporary Fix

The Act is a temporary fix, which sunsets on December 31, 2012, immediately after the next election cycle. It is impossible to predict whether it will be extended in either its current or some modified form, especially given the fact that it is a hot button issue with both major political parties. If Congress fails to act, the Act will lapse and on January 1, 2013, the gift, estate and GTS exemptions will be \$1 million with a top tax rate of 55%. Since changes are effective only for the next two years this makes the reliance on the \$5 million exemption precarious.

## State Estate Taxes

Many states, including New York and New Jersey, have separate estate tax regimes with lower applicable exclusion amounts than the federal applicable exclusion amount. In New York, individuals with estates over \$1 million will need to address planning to minimize the impact of the New York estate tax. Planning is also important if you have property in more than one state, as state estate tax laws can differ significantly.

## Portability vs. Credit Shelter Planning

One of the more notable provisions contained with the Act is the portability provision, which provides that if one spouse does not fully utilize his/her entire \$5 million applicable exclusion amount, the unused portion can be used by the surviving spouse's estate. Despite the apparent simplicity of leaving everything to the surviving spouse and relying on portability, there are strong reasons to continue to use credit shelter trust planning.

- Both spouses must die before 2013 in order to benefit from the portability provision;
- There is no portability for state estate purposes;
- The credit shelter trust provides asset protection for the surviving spouse, including any marital claims of future spouses;
- Ensuring that appreciation on the assets contained within the credit shelter trust, which may exceed the applicable exclusion amount at the time of the surviving spouse's death, are not subject to estate tax;
- The credit shelter trust allows the deceased spouse to make sure that the assets in that trust are managed and distributed according to his/her wishes;
- There is no portability of the deceased spouse's unused GST exemption;
- The deceased spouse's unused exemption will be lost if the surviving spouse remarries and survives his/her next spouse;
- The deceased spouse's unused exclusion amount is not indexed for inflation.

## Non-Citizen Spouses

The Act reinstates federal estate taxes on United States-situs property of non-US citizens who are not residents. The increased applicable exclusion amount to \$5 million per person does not apply to non-US citizens who are not residents. US situs property exceeding \$60,000 in value is again currently subject to US estate taxes beginning at graduated marginal rates beginning at 18%. Accordingly, particular vigilance needs to be exercised in structuring the acquisition of US assets such as real property, so as to avoid imposition of US estate taxes at pre-2010 levels.

## SUMMARY

Although the Act provides tremendous opportunities for gift and GST planning for 2010 through 2012, estate planning will remain difficult due to the uncertainty about long-term estate, gift, and GST rates and exemptions. Given the fact that the Act will sunset without further Congressional action in 2012, we are advising clients that it would be prudent to implement estate planning techniques utilizing lifetime gifts before the December 31, 2012 sunset date. As always, we also recommend that clients review their estate plans periodically to make sure that it still meets your goals and/or whenever a significant life event occurs (e.g., birth of a child, death of a spouse, purchase of new home, etc.). Please do not hesitate to contact us with any questions that you might have or if you would like to discuss your estate plan in light of the Act.

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