SUTHERLAND

Trusts and Estates Client Alert

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On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act") into law. In addition to extending the Bush-era income tax cuts originally enacted in 2001, the Tax Relief Act made significant changes to the federal gift, estate, and generation-skipping transfer taxes, including:

- Increasing the federal estate tax exemption to $5,000,000 (less any amount used against taxable gifts during life) and reducing the estate tax rate to 35%. As a result, a married couple, with proper planning, can pass up to $10,000,000 of property to their children or other beneficiaries without incurring any federal estate tax. As was true before, no estate tax is due on any amount left to a spouse (or to certain trusts for a spouse) or to charity.

- Increasing the federal gift tax exemption to $5,000,000 and retaining the gift tax rate of 35%. The Tax Relief Act thus "reunifies" the federal estate and gift tax exemptions and rates. Again, as before, no gift tax is due on gifts to a spouse (or to certain trusts for a spouse) or to charity.

- Increasing the federal generation-skipping transfer ("GST") tax exemption to $5,000,000 and reducing the GST tax rate to 35%. The larger estate and gift tax exemptions can be combined with the increased GST tax exemption to create a substantial legacy of up to $10,000,000 to pass to children, grandchildren, and more remote lineal descendants without the imposition of future transfer taxes.

- Introducing "portability" of the federal estate and gift tax exemptions (but not the GST tax exemption), with the result that any unused portion of the $5,000,000 estate tax exemption of the first spouse to die is available to the surviving spouse for use against his or her lifetime gifts or estate taxes. Thus, if a husband did not use any of his federal gift tax exemption during his life and bequeathed all of his property to his wife, thereby using none of his federal estate tax exemption, his wife would have a $10,000,000 exemption, which she could use for making gifts during her life or at her death against the estate tax imposed on her estate (less any amount used by her against taxable gifts during life).

- Beginning in 2012, indexing of the federal estate, gift, and GST tax exemptions for inflation.

Importantly, these changes are only effective until December 31, 2012. Unless new legislation is enacted before the end of 2012, the applicable federal transfer tax exemptions and rates will revert to their much less-generous 2001 levels. Because of the substantial increase in the exemption amounts, it is now very important both to reexamine the provisions of your current estate planning documents and to consider more active lifetime gifting strategies. Your will or revocable trust likely contains formula provisions that, due to the increased estate (and GST) tax exemption, will cause your property to pass differently than you anticipated when you executed the instrument. A discussion of this issue is set out below, with examples that illustrate how the increase in the estate and GST tax exemptions can result in such changes.

In the remainder of this Client Alert, we describe:

- The potential impact of these changes on existing estate plans (page 2);
- The effect of portability of estate tax exemptions between spouses (page 5);
- Special issues facing residents of jurisdictions that impose a state estate tax (including the District of Columbia and Maryland) (page 5);
- Several gifting opportunities that may be of interest to you (page 6); and
- Scheduled changes to the federal transfer tax laws after 2012 (page 9).

Potential Impact on Formula Provisions in Estate Planning Documents

Although the increase in the federal estate tax exemption under the Tax Relief Act is beneficial, it may have unintended effects on existing estate plans. As we discussed in our March 2010 update, many wills and revocable trusts allocate property at death based on formulas that are intended to (a) utilize available estate tax exemptions, (b) maximize the benefit of the GST tax exemption, and (c) minimize and/or defer federal and state estate taxes.

Formulas, rather than exact exemption amounts, are commonly used so that clients need not change their instruments every time Congress makes changes to the available exemptions. However, when there are substantial changes to the federal transfer tax laws, it is important to revisit the provisions of your estate planning documents to ensure that your property will pass at your death as you intend. While the increases in available gift, estate, and GST exemptions are welcome, the effect of such increases on these formula provisions may create unintended consequences.

Consider, for example, the current plan of many married couples, which is designed to avoid all federal estate tax when the first spouse dies and to minimize the overall tax. Under such a plan, the assets of the first spouse to die are divided into two portions: a so-called “Family Trust,” holding property with a value equal to the federal estate tax exemption, and a "Marital Share." The Family Trust is ordinarily for the benefit of the surviving spouse and the couple's children, although in some instances it is for the benefit of the spouse only or the children only. The Marital Share may pass outright to the surviving spouse or may be held in trust for his or her sole lifetime benefit. This plan allows a married couple to take full advantage of the federal estate tax exemption of the first spouse to die and to defer any federal estate tax until the death of the surviving spouse.

In 2009, the federal estate tax exemption was $3,500,000, and, in 2010, prior to the passage of the Tax Relief Act, there was no federal estate tax. Therefore, in 2009, in a $6,000,000 estate, the formula described above would have allocated $3,500,000 (the value of the federal estate tax exemption) to the Family Trust, and the remaining $2,500,000 to the Marital Share. Prior to the enactment of the Tax Relief Act, in 2010, the formula would have caused all the property of a person dying in 2010 to pass to the Family Trust.

Under the terms of the Tax Relief Act, in a $6,000,000 estate, the formula described above would allocate $5,000,000 (the value of the federal estate tax exemption) to the Family Trust, and the remaining $1,000,000 to the Marital Share. By automatically allocating more property to the Family Trust and less to the Marital Share, the formula might have the effect of reducing the surviving spouse's access to funds, which would likely be inconsistent with the client's intent.

The changes to the federal estate tax exemption and GST tax exemption made by the Tax Relief Act may have a similar effect on your estate planning documents. And while these changes may be more pronounced on the estate plans of married couples, which frequently utilize formulas involving the federal estate tax marital deduction, any estate plan that allocates property based on the available federal estate tax exemption or the available federal GST tax exemption may be affected by the changes made by the Tax Relief Act. Your response to these changes will necessarily depend on the unique circumstances relating to your family, finances, and personal preferences. Therefore, we encourage you to contact us to review the effect of the changes on your current estate planning documents and to consider whether to revise your plan in response to these changes and your goals. Additional examples are provided below that illustrate the impact of the changes made by the Tax Relief Act on other estate planning formulas frequently used in client documents.

Examples of the Impact on Formula Provisions

Consider an estate of $6,000,000 and the following common formulas found in estate planning documents.

- I give to the Family Trust the ***largest amount of my property that I can pass free of federal estate tax***, and I give the residue of my estate to the Marital Share.

Date	Amount to Family Trust	Amount to Marital Share
Prior to Tax Relief Act	$3,500,000	$2,500,000
After Tax Relief Act	$5,000,000	$1,000,000

- I give to the Family Trust ***the amount that would cause my taxable estate to be the largest it can be without resulting in any federal estate tax***, and I give the residue of my estate to the Marital Share.

Date	Amount to Family Trust	Amount to Marital Share
Prior to Tax Relief Act	$3,500,000	$2,500,000
After Tax Relief Act	$5,000,000	$1,000,000

- I give to "X" Charity ***that sum necessary to reduce my federal estate tax to zero, after taking into account my available estate tax exemption***, and the residue to the Family Trust.

Date	Amount to Family Trust	Amount to Charity
Prior to Tax Relief Act	$3,500,000	$2,500,000
After Tax Relief Act	$5,000,000	$1,000,000

- I give to my grandchildren ***the maximum amount of property that I can pass to them free of the federal generation-skipping transfer tax***, and the residue to the Family Trust.

Date	Amount to Family Trust	Amount to Grandchildren
Prior to Tax Relief Act	$2,500,000	$3,500,000
After Tax Relief Act	$1,000,000	$5,000,000

As these examples illustrate, after the changes made by the Tax Relief Act, provisions based on formulas may produce unintended results, especially when you consider that the federal estate tax exemption and federal GST tax exemption may have been as low as $1,000,000 (or less) when your existing estate planning documents were originally prepared and executed. As noted above, we encourage you to contact us to review the effect of the changes on your current estate planning documents, and to consider whether to revise your plan in response to these changes and your goals.

Does Portability Eliminate the Need for Estate Planning?

Prior to enactment of the Tax Relief Act, estate planning for a married couple would, as noted above, ordinarily include the division of assets between spouses during life and preparation of estate planning instruments that created a Family Trust to ensure that, regardless of which spouse dies first, he or she would have sufficient assets with which to utilize the available federal estate tax exemption. The estate plan was commonly structured in this way because, under prior law, any federal estate tax exemption of the first spouse to die that was not used was lost and was not available to the surviving spouse.

The Tax Relief Act introduced "portability" of the federal estate tax exemption between married couples, thereby providing that any unused federal estate tax exemption of the first spouse to die would be available to the surviving spouse, and ensuring that a married couple would have available to them the full $10,000,000 of federal estate tax exemption, regardless of the allocation of their assets or the order in which their deaths occurred.

While portability may indeed simplify many estate plans, it does not eliminate the need for estate planning or the role of trusts in estate planning for married couples. Specifically, trusts (such as Family Trusts) can be used to allow future appreciation of assets to escape tax at the surviving spouse's death, and they remain useful vehicles for asset management, creditor protection, state estate tax minimization, and planning for grandchildren and more remote descendants. Furthermore, depending upon future tax legislation, it is quite possible (i) that portability will not be available after December 31, 2012, and (ii) that the unused federal estate tax exemption of a first spouse who dies between now and December 31, 2012, will not be available for use by a surviving spouse who lives beyond December 31, 2012.

State Estate Tax Concerns Regarding Formula Provisions

Although many states (including Virginia and Georgia) do not currently impose a state estate tax, a number of jurisdictions (including Maryland and the District of Columbia) do. In general, these state estate taxes – although deductible under current law when calculating the federal estate tax – will be payable to the extent that property in excess of the state estate tax exemption (currently $1,000,000 for Maryland and the District of Columbia) passes to persons other than the surviving spouse (or, in certain states, including Maryland, to a trust for the spouse's sole lifetime benefit) or to charity.

As noted above, the estate plan of many married couples provides for the creation of a Family Trust funded with an amount of property equal to the available federal estate tax exemption, with any additional property passing to the surviving spouse (either outright or through a marital deduction trust). This type of plan eliminates any federal estate tax due at the death of the first spouse and allows the property passing to the Family Trust to avoid estate tax at the death of the surviving spouse. However, funding the Family Trust with the $5,000,000 federal estate tax exemption amount will cause the estates of residents of jurisdictions such as Maryland or the District of Columbia. to pay as much as $391,600 in estate taxes – the tax imposed on the excess of the federal estate tax exemption over the $1,000,000 state estate tax exemption – at the death of the first spouse to die, rather than to defer such tax until the death of the surviving spouse.

There are several strategies available to minimize or defer these state taxes:

- Leaving more property to the surviving spouse. This can reduce or eliminate the state estate tax at the death of the first spouse and defer it until the death of the surviving spouse, but depending upon whether portability is retained after 2012, may prevent full use of the first spouse's federal estate tax exemption.

- In some jurisdictions (including Maryland), a special state-only marital deduction trust is available, which can defer some or all of the state estate tax without wasting any of the federal estate tax exemption.

- Many jurisdictions, including the District of Columbia and Maryland, that impose a state estate tax do not currently impose a gift tax. Therefore, lifetime gifts by either spouse or by a single person can reduce the assets subject to state estate tax, and in some cases, can eliminate state estate tax altogether. This may be particularly beneficial with the increased federal gift tax exemption under the Tax Relief Act.

Planning Opportunities – A Good Time to Consider Gifts

The increased federal gift tax exemption has created opportunities to make substantial gifts, whether outright to family members or to trusts for their benefit. When such increased gift tax exemption is used in conjunction with the increased GST tax exemption, such gifts can be structured to benefit not only your children, but also your grandchildren and more remote descendants. However, because the changes made by the Tax Relief Act are only effective through December 31, 2012, it is quite possible that the opportunity to utilize the increased $5,000,000 federal gift tax and GST tax exemptions will only be available for the next two years. Therefore, it is critical to consider implementing a gifting program and utilizing some portion or all of the increased gift and GST tax exemptions before the end of 2012.

You should note that if future legislation results in a federal estate tax exemption of less than $5,000,000, it is possible that some of the gift tax savings on gifts made prior to the end of 2012 may be recaptured – in the form of an estate tax – at the donor's death. However, even if this were to occur, the key benefits from making such gifts, including the removal of the future income and appreciation of the gifted property from the donor's estate, will remain.

In addition, in structuring new gifts, the current low interest rates and depressed values of certain assets may make more specialized gifting techniques – for example, grantor retained annuity trusts, sales to grantor trusts, intrafamily loans, and gifts to charitable lead annuity trusts – especially advantageous at this time.

Each of these techniques, described briefly below, is complex, and some or all of them may not be appropriate for you.

Grantor Retained Annuity Trusts ("GRATs")

Under the terms of a GRAT, you would make a gift of assets to a trust and retain the right (the "Retained Interest"), for a specified number of years, to receive an annuity based on the value of the assets contributed to the trust. The annuity can be paid from the earnings of the trust assets, from the proceeds of the sale of such assets, or by a distribution back to you of the trust assets. At the end of the Retained Interest, any remaining trust assets are distributed in accordance with the provisions of the GRAT instrument (e.g., outright to your children or in further trust for your children or grandchildren).

The taxable gift upon creation of the GRAT equals the value of the property transferred to the trust, reduced by the actuarial value of your Retained Interest. Typically, under current law, GRATs are designed so the Retained Interest is large enough that the taxable gift is relatively small in comparison to the value of the property transferred to the GRAT (i.e., often less than $1,000). The value of this Retained Interest is a function of (a) the payout percentage retained by you, (b) the duration of the Retained Interest, and (c) the so-called "Section 7520" interest rate (a discount rate) provided monthly by the IRS (2.4% in January 2011). In general, if the GRAT property appreciates at a higher rate than the Section 7520 rate, more property would be distributed to your children or the other beneficiaries at the termination of the GRAT. Congress has recently considered legislation that would have limited the efficacy of GRATs; however, no such legislation is currently being considered.

Sale to Grantor Trust

Another option would be to create an irrevocable trust for your children and grandchildren and to make a gift of assets, such as cash or listed stocks, to such trust. The trust could then purchase from you interests in a limited liability company ("LLC"), limited partnership, or other closely held business in exchange for a promissory note. The promissory note would bear interest at the so-called "applicable federal rate," or "AFR." While that rate is reset by the IRS each month, your note would bear the rate that applies in the month the sale occurs. (The AFR for a loan of greater than three years and less than or equal to nine years, which is also referred to as the "mid-term applicable federal rate," is only 1.95% for

January 2011). Following the sale, you would hold a promissory note that would not appreciate in value, and the trust would hold the LLC, limited partnership, or other closely held business interests and any appreciation. Stated differently, you could potentially "freeze" the value of your assets (by holding a promissory note) and move all the appreciation (above the interest rate on the note paid to you) to the trust.

You should note that because the trust would be treated as a "grantor" trust – that means that for federal income tax purposes, you are treated as owning the trust property and are taxable on its income – the sale by you of LLC, limited partnership, or other closely held business interests would not give rise to capital gain. A grantor trust is also beneficial from a gift planning perspective, as you would pay the income tax on the income received by the grantor trust (and that would benefit your children and grandchildren) – without such amounts being treated as additional gifts by you.

Intrafamily Loans

The AFRs set by the IRS (discussed above) establish the minimum rate of interest that a promissory note must bear to avoid adverse tax consequences. For January 2011, the short-term AFR (for loans having a term of three years or less) is 0.43%, the mid-term AFR (as discussed above) is 1.95%, and the long-term AFR (for loans with a maturity of greater than nine years) is 3.88%. As a result of these low rates, this is a good time to consider making loans to your children or grandchildren or trusts for their benefit. By doing so, you could potentially "freeze" the value of your assets (by holding a promissory note) and your children could use the money towards the purchase of a home, for investments, or for any other use. Such a loan could provide for payments of interest annually, with the principal due as a balloon payment at the end of the term of the loan, or can provide for amortization of principal and interest. However, the loan must be a legal obligation of the borrower and must be repaid and/or refinanced (under the then-current AFRs) at the expiration of its term. In addition, if you die while the promissory note is outstanding, it will be considered an asset of your estate.

Charitable Lead Trusts ("CLTs")

Generally, a charitable lead trust involves a gift of cash or property to an irrevocable trust from which an annual payment – in the form of a fixed annuity or a payment that varies with the value of the trust – is made to charity for a specified number of years. Upon the expiration of the payment period to charity, any remaining trust assets pass to your children (or grandchildren or other beneficiaries that you designate) free of gift or estate tax. Further, a CLT can be established in a manner to minimize GST tax. The contribution to a CLT can be structured to provide a gift tax charitable deduction for all or part of the assets contributed. The value of the gift to the remainder beneficiaries will be based on the total value of the assets transferred to the trust less the value of the charity's interest in the trust, which is determined by the duration of the CLT and the size of the annual payment to charity. Lower interest rates reduce the required payments to charity necessary to minimize the size of the gift to the remainder beneficiaries. A CLT would be an appropriate planning technique if your planning goals include benefiting one or more charitable organizations.

Gifts – Basis

With respect to any gift, it is important to consider the basis of the assets transferred. Basis is generally equal to the cost of an item of property, with certain adjustments provided by tax law. Basis is important in determining gains when the property is sold. In general, for any gift of appreciated property you make to someone during your life, the donee receives your basis in the property. This is called "carryover basis." However, under current law, the recipient of a bequest at death receives a basis in the property equal to the date-of-death fair market value of the asset. This is called "adjusted basis." Therefore, if you plan to make gifts of assets to your children (or other beneficiaries), you should compare the benefits of transferring such assets (for example, to shift the future income and appreciation of such property to the beneficiaries) against the basis the beneficiary will receive in the property determined by when the transfer is made (i.e., carryover basis during your life or adjusted basis at your death).

Scheduled Changes to Federal Transfer Tax Laws After 2012

As indicated above, the provisions of the Tax Relief Act are only applicable through the end of 2012. If Congress does not act again prior to 2013, the changes enacted by the Tax Relief Act are scheduled to "sunset," and on January 1, 2013, the federal transfer tax laws will return to what they were in 2001. Under those rules:

- The federal estate tax exemption would be limited to $1,000,000, and the estate tax would be imposed at graduated rates with a top rate of 55% (and an effective rate of 60% for certain large estates).

- The federal gift tax exemption would be limited to $1,000,000, and the gift tax would be imposed at graduated rates of 41% to 55% on cumulative gifts in excess of the federal gift tax exemption.

- There would be no portability of the federal estate tax exemption or the federal gift tax exemption.

- The federal GST tax exemption would be limited to $1,000,000 (as adjusted for inflation after 1998), and the GST tax would be imposed at a rate of 55% on transfers to grandchildren or younger generations (or trusts for their benefit).

- None of the federal estate, gift, or GST tax exemptions would be indexed for inflation for future years.

If the recent past teaches us anything, it is that we may well be waiting until December 2012 to determine what the federal transfer tax laws will be in 2013 and the future.

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If you have any questions about this Client Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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