Art Law Gallery

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The Art Of Taxes: Major Changes To The Federal Transfer Tax System

Ars longs, vita brevis. Art is immortal, artists are mortal. Taxes impinge on every part of the art world and are a concern for both artists and collectors. Planning for and administering estates of artists and owners of art collections raises unique business management, income tax, transfer tax, and estate planning issues. Such planning often requires an interdisciplinary approach that addresses copyright law, tax and estate planning (including, but not limited to, charitable giving), business management, and knowledge of the valuation of a creative work. Substantial changes were made to the Federal estate, gift and generation-skipping transfer taxes by The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act").

As a preliminary matter, it is essential to understand that ***the changes made by the 2010 Act will only apply for two years*** – for 2011 and 2012 only. Unless Congress acts to make these changes permanent (or extends them even further), we will once again face the prospect of reverting back to the transfer tax laws that applied in 2001. Nevertheless, it is necessary to understand the new transfer tax laws and plan accordingly. Further, other matters covered by the 2010 Act – such as the extension of the "Bush income tax rates" – are not covered by this Alert.

The Increased and Newly Reunified Exemptions

Perhaps the most significant change made by the 2010 Act is the increase in the estate, gift and generation-skipping transfer tax (the "GST tax") exemptions to $5 million. Recall that the estate and GST tax exemption was $3.5 million in 2009, and the gift tax exemption remained at $1 million. Now, all of the transfer tax exemptions are reunified and increased. This means that a person's taxable transfers will not be subject to a federal transfer tax until they cumulatively exceed $5 million (or $10 million for a married couple). This change will dramatically reduce the number of estates that will be subject to estate tax in future years. This change will also allow persons who have already used up their $1 million gift tax exemption to make additional large gifts (of up to $4 million per person and $8 million per couple) to their children, grandchildren or other donees without paying any additional gift tax.

Under the 2010 Act, the $5 million transfer tax exemption will be indexed for inflation beginning in 2012, but since these changes are set to expire at the end of 2012, this inflation adjustment is of marginal importance for now.

The increased $5 million exemption for the estate tax and GST tax is made retroactive to January 1, 2010. However, the increased $5 million exemption for the gift tax is only effective on January 1, 2011, so the current $1 million gift tax exemption will continue to apply for all gifts made in 2010. This means that it generally will make sense to defer making large taxable gifts until 2011, when the additional $4 million in exemption will be available to shelter those gifts from gift tax and the same 35% rate on gifts over the exemption amount will apply. ***However some generation-skipping gifts may be advantageous in 2010, as discussed below.***

The Reduced Transfer Tax Rate

The 2010 Act also reduced the tax rate on all taxable transfers to 35%. Recall that the estate and GST tax rate in 2009 was 45%, though the gift tax rate was reduced to 35% in 2010 for all taxable gifts over the $1 million exemption. Now, the tax rate on all taxable transfers over the applicable exemptions will be the same flat rate of 35%.

The "Optional" Estate Tax For 2010 Estates

The estate tax was repealed in 2010, subject to a modified “carry-over” basis regime. This meant that the estate of a person dying in 2010 (a “2010 estate”) faced no estate tax, no matter the size of the estate, but the assets in the estate did not receive a new, fully stepped up basis for income tax purposes. (Under the prior law, a full step-up in income tax basis at death was provided.) Instead, estate assets could receive a partial basis adjustment of up to $1.3 million (with another $3 million of basis adjustment available for property passing to a surviving spouse, either outright or in qualifying trusts). In effect, the estate's “savings” from the estate tax repeal were offset somewhat by the "cost" of higher capital gains taxes incurred when estate assets were later sold by the estate or its beneficiaries.

The 2010 Act generally applies the new estate tax law to a 2010 estate. Thus, absent the election discussed below, (i) a 2010 estate will have the increased $5 million exemption, (ii) any estate value over the exemption will be taxable at the reduced 35% tax rate, and (iii) the 2010 estate will receive a fully stepped up basis in the estate assets for income tax purposes.

However, the 2010 Act gives a 2010 estate the option ***not*** to apply the new estate tax laws to it, as follows:

1. If a 2010 estate prefers NOT to be subject to the new estate tax law, the 2010 estate must make an affirmative election to “opt out” of the new estate tax law. By opting out, the 2010 estate will be choosing to be subject to the “repeal” rules – that is, no estate tax will be payable by the 2010 estate, no matter its size, but its assets will be subject to the modified carry-over basis rules. For very large 2010 estates, opting out will likely be the better choice, since the higher capital gains taxes these 2010 estates (or their heirs) will face will be much lower than the 35% estate tax they would pay, and the capital gains taxes are paid only when the assets are in fact sold, which may be many years later (if ever).

2. In order to “opt out” of the new estate tax laws, the executor or trustee of the 2010 estate must timely file an estate tax return and make the affirmative “opt out” election on that return. The earliest deadline for filing this estate tax return is September 19, 2011 (the first business day that is nine months after the date of enactment of the 2010 Act). The earliest due date for the carry-over basis allocation report that is due for a 2010 estate that opts out of the new estate tax law will also be September 19, 2011.

3. For any 2010 estate that does NOT want to opt out of the new estate tax laws, the earliest deadline to file its estate tax return and pay any estate tax that is due is also September 19, 2011. Of course, if the gross value of the 2010 estate falls below the $5 million exemption, there is no requirement for it to file the return.

The key point for executors and trustees of 2010 estates is that the new estate tax laws are the “default” rules for ***all*** 2010 estates – if the affirmative “opt out” election is ***not*** made on a timely filed estate tax return, the new estate tax laws ***will apply*** to the 2010 estate. ***It is critically important that the executor or trustee of any 2010 estate consult with his or her legal advisor about whether and how to make this election.***

The New Portability Rules – Brave New World For Married Couples!

Under prior law, if a married person died without using up all of his or her estate tax exemption, the remaining unused exemption was simply lost. Similarly, under prior law, if a married couple wanted to fully utilize both of their estate tax exemptions, they had to do conventional “A/B” trust planning, creating an irrevocable bypass trust at the first death and funding it with the deceased spouse's assets up to the exemption amount.

The 2010 Act introduces a brand new concept that could revolutionize conventional estate planning for married couples – the concept of portability of unused exemptions for estate and gift taxes.

Under the portability rules, for deaths in 2011 or later the executor or trustee of a deceased spouse's estate can transfer to the surviving spouse all of the deceased spouse's unused estate tax exemption. (The portability rules create a brand new concept with an awkward acronym – the “deceased spousal unused exclusion amount” or DSUEA.) After the surviving spouse receives the DSUEA, the surviving spouse's estate tax exemption is now the combination of the surviving spouse's own estate tax exemption plus the DSUEA, and upon the surviving spouse's later death his or her estate will only be subject to the 35% estate tax to the extent the estate exceeds that combined exemption.

> ***Illustration.*** A married couple have a community property estate worth $12 million, and they have used up none of their estate tax exemptions through lifetime gifts. The husband dies in 2011, leaving his entire estate of $6 million outright to his wife (either through a will or trust or otherwise). Because the husband's estate qualifies for the unlimited marital deduction, it uses up none of his $5 million estate tax exemption. The husband's executor transfers that $5 million of DSUEA to the surviving wife. The wife then dies in 2012, and her total estate is $12 million. Her estate's exemption is the combination of her own $5 million exemption and the $5 million of DSUEA. Thus, her estate is taxable only on $2 million, and at 35% her estate tax is $700,000. Under the old law without portability, her estate would be taxable on $7 million, and at 35% the estate tax would be $2.45 million.

In order to transfer the DSUEA to the surviving spouse, the deceased spouse's executor or trustee must timely file an estate tax return and make an election to permit the surviving spouse to use the DSUEA. ***Thus, even for estates that fall under the filing threshold for estate tax returns (which is the $5 million exemption amount), it will still be necessary for the estate to incur the expense of filing an estate tax return if the surviving spouse is planning to use the deceased spouse's “portable” unused exemption.*** If the election is not made on a timely filed return, the DSUEA is lost and more estate tax may be payable at the second death. Thus, for "smaller" estates the executor or trustee will have to consider the possible advantage gained by filing the estate tax return solely to transfer the DSUEA to the surviving spouse, at the cost of the return preparation effort and expense.

The portable DSUEA inherited by a surviving spouse can also be used for gift tax purposes by the surviving spouse. Indeed, it can even be used by the surviving spouse's new spouse upon remarriage, to shelter gifts made by the new spouse (but only if the spouse with the DSUEA allows it to be used by the new spouse). However, if a remarried spouse with DSUEA dies and her own estate does not fully use up the DSUEA, her new spouse cannot "inherit" her unused DSUEA from her earlier spouse.

On its face, portability seems to be a tremendous estate planning tool that may permit much more streamlined planning for married couples (for example, it will allow for a simple will or trust that leaves everything outright to the surviving spouse and does not create an irrevocable bypass trust at the first death). In addition, assets that are left outright to a surviving spouse will receive a second stepped up basis at the survivor’s later death.

However, portability does have certain drawbacks that the married couple must consider when creating their estate plan. Those drawbacks include:

1. The DSUEA is not indexed for inflation. In contrast, if assets are left in a bypass trust, the appreciation in value of the assets will not be subject to estate tax at the second death. (Remember the good old days when assets increased in value between the first and second deaths? Those good old days may return, and estate planning often benefits those who think long term.) For example, if a bypass trust is funded with $5 million at the first death, and the bypass trust grows in value to $6 million by the time of the second death, that $1 million increase in value will not be subject to the 35% estate tax. Under the DSUEA rules, the entire $6 million would be part of the surviving spouse's estate, with only a $5 million DSUEA to shelter those assets from estate tax. The same $1 million value increase would be taxable at the survivor's death at an estate tax cost of $350,000. (But note, the estate tax savings from using a bypass trust and sheltering future appreciation could be offset by the capital gains taxes payable on the appreciated bypass trust assets when they are sold, since the bypass trust will not get a stepped up basis at the survivor's death.)

2. The DSUEA can possibly be lost or reduced upon remarriage. For example, if a surviving wife (who has $5 million in DSUEA from her first husband) remarries ***<u>and</u>*** that new spouse dies first and his estate uses up all of his $5 million estate tax exemption (for example, by leaving his estate to his children from a prior marriage), the widow loses all of her $5 million in DSUEA from her first husband – in other words, only the "last" deceased spouse's DSUEA can be used by a surviving spouse. This rule may create some interesting new issues to be considered upon a possible remarriage, and give rise to romantic questions like "How much DSUEA will I lose, and how much more in estate taxes will my kids have to pay, if I marry you and you die first?" This could also give step-children yet another reason to resent their new step-parent!

3. The DSUEA cannot be used for GST tax purposes, so if a married couple wants to do "dynasty planning" to fully utilize their combined $10 million of GST tax exemption, they must still create a bypass trust at the first death to use the first spouse's $5 million of GST tax exemption.

4. The new portability rules, like all the other new laws in the 2010 Act, are scheduled to sunset or expire after 2012. Thus, until and unless the portability rules are made permanent by Congress, it is inherently problematic to rely on them in creating one's estate plan.

<u>The New GST Tax Rules</u>

Under the 2010 Act, the GST tax rate for all GST-taxable transfers made in 2010 is zero. This means that any gifts made by grandparents to grandchildren or great-grandchildren, etc., in 2010 (or any distributions made by estates of deceased persons or from dynasty trusts to the settlor's grandchildren or great-grandchildren, etc. in 2010) will not be subject to the GST tax, without having to use any of the transferor's GST tax exemption. This "zero tax rate" rule for 2010 GST-taxable transfers is consistent, of course, with the repeal of the GST tax in 2010. However, it also helps to clarify that any gifts placed by a grandparent in 2010 into a trust or custodianship account for the benefit of a minor grandchild will not be subject to GST tax when the money later comes out of the trust or custodianship account to that grandchild. Because of the technical rules applicable to multi-generation trusts, however, if no GST exemption is allocated to the trust, the normal 35% GST tax for a transfer during 2010 is avoided only at the first generation. Thus, if a dynasty trust for grandchildren and lower generations is created and funded in 2010, future distributions from the dynasty trust at the grandchild level are free of GST tax, but future distributions at the great-grandchild (or lower) level will be subject to the 35% GST tax.

Under the 2010 Act, the increased $5 million of GST tax exemption can also be allocated to GST-taxable transfers made in 2010, for example, to protect transfers to several younger generations. If a donor wishes to avoid having the $5 million of GST exemption automatically allocated to any GST-taxable transfers made in 2010 (for example, because the donor wants to take advantage of the zero tax rate that applies to GST-taxable transfers in 2010), the donor must affirmatively elect out of the automatic allocation on a timely filed gift tax return. It is therefore very important to consult your estate planning advisor about any 2010 gifts, and whether to allocate or elect not to allocate GST exemption to those transfers. Those decisions must be made before your 2010 gift tax return is due (which is the same date your 2010 income tax return is due).

Because the "repeal" of the GST tax remains in effect for the rest of 2010, there is still a limited opportunity for clients who want to make significant generation-skipping gifts without using their $5 million of GST exemption to do so, and for the trustees of generation-skipping trusts that permit distributions to grandchildren or younger generations to make distributions to those beneficiaries this year without any GST tax. ***You should consult with your estate planning attorney immediately if you want to take advantage this year of the limited opportunity to make substantial gifts to grandchildren free of the GST tax.***

Items Not Covered By the 2010 Act

Certain estate planning tools and techniques and other income tax rules were not changed by the 2010 Act. For example:

1. Valuation Discounts. The 2010 Act contains no restrictions on valuation discounts associated with gifts of closely held, non-publicly traded business interests. Indeed, with the increase in the lifetime gift tax exemption to $5 million, valuation discounts through gifts of family limited partnership or limited liability company interests offer even greater opportunities to leverage one's transfer tax exemption and transfer more wealth to the next generation.

2. GRATs. Grantor retained annuity trusts, or GRATs, had been slated for new restrictions which would greatly diminish their utility as a leveraging technique. The 2010 Act includes no such restrictions on GRATs. However, with the increased gift tax exemption, gifts and sales to so-called "defective grantor trusts" may now provide even greater leveraging opportunities than GRATs.

3. No IRA RMD Waiver For 2010. The requirement to take the "required minimum distribution" (or RMD) from a person's IRA was waived in 2009. The 2010 Act did not extend this waiver to 2010. So if you haven't yet taken your RMD for 2010 from your IRA, you must do so before year-end to avoid the 50% penalty tax.

   The 2010 Act did extend to 2010 and 2011 the law allowing a direct rollover of up to $100,000 from an IRA to charity, for participants over age 70-1/2. A direct charitable rollover may satisfy the 2010 RMD requirement. Because this extension was passed so late in the year, the law allows a participant to complete the charitable rollover before January 31, 2011, and treat it as a 2010 distribution.

4. Roth Conversion – 2010 Action Required for 2-Year Payment Option. The ability of taxpayers to convert a traditional retirement plan to a Roth IRA, including the option to recognize the income – and pay tax – on the conversion over the two succeeding years instead of the current year, was not changed. Now that existing income tax rates have been extended through 2012, this certainty may make Roth conversions more attractive to some clients. The option to pay the tax in the two succeeding years is only available for 2010 conversions, however, so clients who are considering a Roth conversion with the 2-year payment option must act immediately.

5. Crummey Withdrawal Powers. Various legislative proposals have called for the disallowance of "Crummey" withdrawal powers from irrevocable trusts. Those withdrawal rights can allow donors to qualify their gifts to irrevocable trusts – such as irrevocable life insurance trusts or minors' trusts – for the gift tax annual exclusion (which is currently $13,000 per year per donee). The 2010 Act does not disallow Crummey withdrawal powers, so they remain a viable technique.

Conclusion

The 2010 Act has made many major changes to the federal transfer tax system. Some of those changes will have a dramatic effect on estate planning, especially for married couples, but the effect is somewhat muted by the temporary, two-year "life span" of the 2010 Act's changes. Sadly, planning one's estate remains somewhat in flux until Congress acts to make these changes permanent. Nevertheless, it is important to accurately consider what, if any, changes to make to your estate plans, what gift techniques you should consider implementing, and if relevant, what should be done in 2010 estate and trust administrations, in light of the dramatic changes made by the 2010 Act.