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Estate, Gift and Generation-Skipping Transfer Tax Provisions of the Tax Relief Act of 2010 or Wealth Planning Becomes More Complicated

By R. Thomas Groves, Jr. and Sam K. Hildebrand

On December 17th, President Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (referred to in this e-Alert as "the Act"), which resulted from the compromises reached by the President and Republican congressional leaders involving the extension of the Bush income tax cuts and of payments to long-term unemployed persons as well as important compromises in the estate, gift, and generation-skipping transfer tax laws. The Act represents a bipartisan effort, and there is not generally complete satisfaction with all of the provisions of the Act on both sides of the aisle.

Although the Act is a welcome gift from Washington in the closing days of 2010, in the sense that it gives us some "breathing room" with respect to certain tax planning issues that would otherwise have reared their heads at the beginning of 2011, in many respects the Act creates more significant and problematical issues resulting primarily from the fact that it does not solve those issues. Rather, it "defers" the need to address solutions to those issues until 2013, when many of the provisions of the Act expire.

The provisions of the Act dealing with estate, gift, and generation-skipping transfer ("GST") taxes include the following:

Exemption Amounts and Tax Rates. The Act provides that the estate and GST exemption amount will be $5 million per person in 2010 through 2012, and that the gift exemption amount will continue at $1 million for 2010 and increase to $5 million in 2011 and 2012. The exemption amount is indexed from 2010, beginning in 2012. The tax rate of 35 percent will apply for estate and gift taxes for 2010 through 2012 and for generation-skipping transfer taxes for 2011 and 2012.

2010 Transition and Election Concerning Carryover Basis. Prior to the Act, the estate tax did not apply to estates of persons dying in 2010. However, with two exceptions, the income tax bases of assets included in the estate of a person dying in 2010 were "carried over" from the income tax bases of the deceased person – that is, the income tax bases remained the same as the income tax bases of the deceased person at the time of his or her death (whereas for persons dying in any year before or after 2010, the income tax bases of his or her assets were generally adjusted to be equal to the fair market value of those assets at the date of the person's death – the so-called "basis step up" rule).

One of the two exceptions to the "carryover basis" rule for 2010 allows the income tax bases of assets to be increased, up to fair market value on date of death, by up to an aggregate of $1.3 million. The second exception applies to married persons dying in 2010 and allows the income tax bases of assets that pass from the deceased spouse to (or in certain trusts for) the surviving spouse to be increased up to fair market value on date of death, by up to an aggregate of $3 million.

Under the Act, the estate tax, with its $5 million exemption amount and 35 percent tax rate, DOES apply to persons dying in 2010, and the basis step up rule (not the carryover basis rule with its two exceptions) will generally be applicable as before 2010. However, executors of estates of persons dying in 2010 have the option to elect NOT to have the estate tax or the basis step up rule apply to the estate, but to have the carryover basis rule (with its two exceptions) apply to the estate. *For persons dying in 2010 with estates of $5 million or less, the choice should be for the estate tax (and basis step up rule) to apply, whereas for persons dying in 2010 with estates in excess of $5 million, the choice should be for the carryover basis rule (with its two exceptions), rather than the estate tax and the basis step up rule, to apply, though there may be circumstances where the other choice would be more appropriate. Executors of the estates of persons dying in 2010 should consult with their tax advisors regarding this election.*

Estate Tax Deadlines With Respect to Persons Dying in 2010. Under the general tax rules, estate tax returns (and any estate taxes owing) are due nine months after the date of death (subject to a six-month extension if a request for extension is filed prior to the nine-month period). Certain elections that may be available to an estate must be made on a timely filed estate tax return. For persons dying in 2010, the Act provides that the estate tax return for the estate of a person dying in 2010 is not due (and any estate tax owing is not due) any earlier than September 17, 2011, the date that is nine months after date of enactment of the Act.

Under the tax laws that apply to the carryover basis rules, the executor of the estate of a person dying in 2010 is generally required to file a carryover basis report with the IRS no later than the due date of the deceased person's federal income tax return (generally, April 15th of the year following the year of death, subject to an automatic six-month extension upon application). Under the Act, if the executor of the estate of a person dying in 2010 elects to have the carryover basis rules apply, the carryover basis report will not be due any earlier than September 17, 2011, the date that is nine months after date of enactment of the Act; however, note that by applying for the automatic six-months extension for the deceased person's final income tax return, the due date of the carryover basis report will be October 17, 2010.

Disclaimers for Estates of Persons Dying in 2010. Persons to whom property passes by reason of the death of an individual are not required to accept that property. State laws recognize this, with "disclaimer" laws that provide that if the requirements of the state disclaimer law are met, the property will not pass to the person making the disclaimer but will pass as if that person had predeceased the person from whom the property passes. To clarify when any such disclaimers would or would not be treated as gifts by the person making the disclaimer, the gift tax laws also set out requirements for a "qualified disclaimer," and provide that a person who makes a qualified disclaimer is not treated as having made a gift of the property subject to the disclaimer.

One of the requirements for a qualified disclaimer is that the disclaimer must be made within nine months after the death of the person from whom the property passes. Under the Act, the deadline for making disclaimers by persons to whom property passes by reason of the death of a person dying in 2010 is extended to September 17, 2010, the date that is nine months after the date of enactment of the Act.

Portability of unused exemption. Under current law, married persons were required to affirmatively plan to take advantage of the estate tax exemption amounts of both spouses. If the predeceasing spouse simply left his or her property to the surviving spouse outright or through Texas inheritance rules, all such property would be included in the surviving spouse's estate and subject to estate tax, to the extent that it existed at the surviving spouse's death. For predeceasing spouses dying after 2010, the Act permits the executor of the predeceased spouse's estate to allow any unused estate tax exemption of the predeceased spouse's estate to be used by the surviving spouse's estate, without the need for any pre-planning between the spouses.

Thus, the surviving spouse's estate will be entitled to the basic estate tax exemption (a newly defined term, which is subject to indexing for inflation, as noted above) plus the predeceased spouse's unused estate tax exemption amount (which does NOT appear subject to any indexing for inflation). If the surviving spouse should remarry and his or her subsequent spouse also predeceases, the surviving spouse's estate would no longer get the benefit of the unused estate tax exemption amount of his or her first spouse's estate, as the unused exemption of only the "last deceased spouse" can be used by the surviving spouse.

This "portability" of a deceased spouse's estate tax exemption applies for purposes of a surviving spouse's gift tax exemption amount, as well, so that any of a predeceasing spouse's unused estate tax exemption amount can, by election of the executor of the predeceased spouse's estate, be added to the surviving spouse's gift tax exemption amount. This portability feature of the Act applies only in 2011 and 2012. *It should be emphasized that assets bequeathed to a surviving spouse and possibly protected by the new portable estate tax exclusion may increase in value, but the portable portion of the first to die spouse's exclusion appears to be frozen at their date of death value, without the benefit of inflation indexing. This will be an important rationale for continuing to advocate for clients to utilize estate tax motivated bypass trusts on the first death.*

GST Tax. In years prior to 2010, the GST tax applied to transfers to a "skip person," a person who was two or more generations below the transferor (ie., a transfer to a grandchild or a younger generation recipient). This tax could be imposed in three circumstances ("GST transfers"): (1) a direct skip, in which the transfer is made directly to the skip person (or a specially designed trust), (2) a taxable distribution, which is a transfer from a trust to a skip person during the term of the trust, and (3) a taxable termination, which is a transfer from a trust to a skip person upon the termination of the trust.

As noted above, beginning in 2010 and continuing in 2011 and 2012, there is a $5 million exemption from the GST tax for such GST transfers. For 2011 and 2012, the GST tax rate is 35%. However, for non-exempt GST transfers occurring in 2010, the GST tax rate is 0%, meaning that no GST tax is imposed on direct skips, taxable distributions, and taxable termination occurring in 2010.

This presents important planning possibilities in 2010. The simplest example of such an opportunity is a direct outright gift to a grandchild in 2010, though there are or may be other opportunities for making transfers to grandchildren or more remote descendants in 2010 that avoid the imposition of generation-skipping transfer taxes which, but for the GST tax rate of 0% in 2010, would be subject to the tax. These include gifts that are made by transfers to custodians for minor grandchildren or more remote descendants under the applicable uniform gifts or transfers to minors act, gifts to 529 Plans, gifts made into certain kinds of trusts, distributions from and terminations of trusts that are not otherwise fully exempt from the GST tax, disclaimers that cause property to pass to grandchildren or more remote descendants, and exercises of powers of appointment over trusts that are not otherwise fully exempt from the GST tax.

While some of those transfers are potentially subject to gift tax, they would not be subject to GST tax. This means that an entire generation level of transfer tax could be avoided, without using GST exemption. This opportunity is available only during the remainder of 2010.

Significantly, and unlike the estate tax exemption, the GST exemption is not portable from a deceased spouse to a surviving spouse. This is yet another reason why the portability concept should not be relied upon, except in limited circumstances.

For more information regarding the Act, please contact **R. Thomas Groves, Jr.** at 214.953.5813 or **tgroves@jw.com** or **Sam K. Hildebrand** at 210.978.2064 or **shildebrand@jw.com**, or any member of the **Jackson Walker Wealth Planning section.**

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