

ALERTS AND UPDATES

Tax Relief Act of 2010: Year-End Planning and Beyond

December 23, 2010

On December 17, 2010, President Obama signed into law the [Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010](#) (the "Act"). In addition to extending the Bush income tax cuts until December 31, 2012, the Act contains numerous changes to the federal estate, gift and generation-skipping transfer (GST) tax laws, which also will expire on December 31, 2012. Below is a summary of the estate, gift and GST tax provisions included in the Act. It is important to note that one change in particular – namely, the elimination of any GST tax on certain 2010 transfers – may require action before year-end, as discussed more fully below.

1. Reinstatement of Estate Tax

The Act reinstates the federal estate tax for decedents dying after December 31, 2009, with a lower 35% maximum tax rate, and with a higher \$5 million federal estate tax exemption than originally scheduled. For individuals who died this year and who do not "opt out" of the estate tax (more on that below), the estate tax is applied retroactively; and estate tax returns are due by September 17, 2011. The Act also repeals the modified carryover basis rules for 2010 (except for estates that opt out of the federal estate tax) and implements the familiar "step-up" in basis regime that existed prior to 2010.

Opt-Out Provisions for 2010 Decedents

The personal representative of the estate of a 2010 decedent has the option to "opt out" of the imposition of federal estate tax. If opting out is elected, the basis of the decedent's assets will be determined under the modified carryover basis rules in effect for 2010, with a basis step-up of approximately \$1.3 million for nonspousal transfers and a basis step-up of \$3 million for certain spousal transfers.

Before electing to opt out of the federal estate tax in 2010, however, the personal representative of a 2010 decedent's estate should consider the changes in the basis rules and how they might affect the basis of assets transferred to beneficiaries. If the taxable estate is \$5 million or less, the personal representative probably would not want to opt out of the federal estate tax in 2010, since under that regime, the estate would obtain a full basis step-up with no federal estate tax. Other situations may require consultation with a tax professional in order to weigh the benefits of obtaining a full basis step-up under the federal estate tax regime or having a zero federal estate tax under the opt-out regime.

2. Portability of Estate Tax Exemption

The Act introduces the concept of "portability" to the estate tax exemption, giving the surviving spouse's estate the ability to use any unused estate tax exemption remaining at the death of the first spouse. Under the Act, a surviving spouse will benefit from the portability provision only after 2010. Nevertheless, while the portability provision is designed to protect the use of each spouse's exemption, there may be tax benefits to continuing to plan specifically for this, as before. Thus, as with other provisions of the Act, individuals may wish to consult with a tax professional before deciding whether or not to rely on the new provision.

3. Gift Tax Exemption Increase to \$5 Million

The Act gives donors a \$5 million gift tax exemption, adjusted for inflation, for 2011 and 2012. The gift tax exemption remains at \$1 million in 2010. The maximum gift tax rate will also be 35%. Any gift tax exemption used during an individual's lifetime will decrease the \$5 million federal estate tax exemption available under the Act. Individuals contemplating year-end gifts may want to consult with a tax professional to determine whether it would be preferable to complete any gifts in 2010 or postpone them until 2011 to take advantage of the increased gift tax exemption.

4. GST Tax Exemption Increase to \$5 Million and 2010 Year-End Planning Opportunities

The Act reinstates the GST tax and increases the GST tax exemption to \$5 million, beginning in 2010. It appears that the \$5 million exemption will be available for all 2010 decedents' estates, regardless of whether an estate has opted out of the federal estate tax. The GST tax rate is zero for 2010 and 35% in 2011 and 2012.

With the zero GST tax rate in 2010, several planning opportunities may be available if completed by year-end. First, individuals contemplating gifts to grandchildren or more-remote descendants may want to make outright gifts to such individuals before year-end and incur no GST tax, provided such gifts can be shielded by the donor's available gift tax exemption (again, \$1 million in 2010). Second, funding trusts for grandchildren and more-remote descendants can be beneficial under the Act if completed by year-end by eliminating GST tax on certain future transfers. Finally, certain trust distributions can be made to grandchildren and more-remote descendants free of GST tax, again provided the distributions are completed by year-end.

The ability to structure transfers this year to eliminate or minimize GST tax can be a significant planning tool, and individuals may wish to consult with legal counsel before year-end to discuss this opportunity.

5. Traditional Planning Techniques

Equally key to what is in the Act is what is *not* in the Act. Valuation discounts are often used with various estate planning techniques (such as family limited partnerships). While it had been rumored that the new tax law would limit the ability to discount the value of assets in estate planning transactions, the Act does not include such limits. As a result, valuation discount planning continues to be an effective estate planning tool, and individuals may want to take advantage of such techniques, in case Congress limits such planning in the future.

In addition, prior legislative proposals would have instituted a minimum ten-year term for an estate planning technique known as a "Grantor Retained Annuity Trust" ("GRAT"), which would have greatly reduced the planning opportunities associated with this type of trust. However, no such provision is included in the Act. Short-term GRATs (*e.g.*, two to three years) appear likely to be viable, at least in the immediate future. As a result, the rush to create GRATs prior to 2011 has eased. Nevertheless, GRATs can be particularly effective when interest rates are low, and with the current applicable rate at its lowest point ever recorded (1.8% in December 2010), there appear to be good reasons to establish a GRAT now.

For Further Information

If you have any questions regarding this *Alert* or would like more information, please contact any of the [attorneys](#) in the [Estates and Asset Planning Practice Group](#) or the attorney in the firm with whom you are regularly in contact.

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