2010 Tax Act Changes to Federal Estate and Gift Taxes - Planning Strategies for Consideration

Significant Estate and Gift Tax Provisions

The Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010 (the "2010 Act") became law effective December 17, 2010. The 2010 Act makes some significant changes to the federal estate and gift tax law. However, the changes are effective for only two years, or through year end 2012. Without further Congressional action, the law as it existed prior to 2001 will be reinstated in 2013. Among other effects, this would result in the federal estate tax exemption equivalent being reinstated at $1 million, a top federal estate tax rate of 55%, and a top gift tax rate of 55%.
Among the significant changes to federal estate and gift tax law in effect through December 31, 2012 are:

- The federal estate tax exemption is $5 million per spouse. Accordingly, with both spouses entitled to a $5 million exemption, a total of $10 million can be transferred free of federal estate tax.
- The top federal estate tax rate is 35%.
- The unused exemption of the first spouse to die is available to the surviving spouse, if elected by the Executor of the deceased spouse's estate.
- For 2011 and 2012, the top gift tax rate remains at 35% *and* a $5 million lifetime exemption applies to gifts made after December 31, 2010 (under prior law, the lifetime gift tax exemption was limited to $1 million).

The following provisions were unchanged by the 2010 Act and remain in effect:

- An unlimited marital deduction exists which permits tax-free lifetime gifts or transfers at death between spouses.
- Individuals are permitted to give tax-free up to $13,000 per year per recipient. With respect to gifts made by spouses to third parties, this amount can be effectively doubled to $26,000 per year per recipient. This so-called annual exclusion renews in full each year. The annual exclusion amount has been indexed for inflation since 1999.

The 2010 Act only applies to federal estate and gift taxes. The Tennessee inheritance tax is *not* identical to the federal estate tax; in particular, only a $1 million exemption exists under Tennessee law, and a top tax rate of 9.5% applies. Furthermore, the Tennessee gift tax annual exclusion does not correspond to Federal law in all respects. For Class A beneficiaries, the annual exclusion is $13,000. The Tennessee gift tax annual exclusion for Class B beneficiaries (i.e., anyone other than a spouse, children, lineal ancestors or descendants, brothers, sisters, sons-in-law or daughters-in-law) remains at $3,000.

Basic Estate Planning Strategies Making Use of the Available Tools

Estate planning is now complicated by the interplay of the following factors:

1. At least through 2012, now that the unused federal exemption of the first spouse to die is available to the surviving spouse (so-called "portability" of the federal exemption between spouses), there is less concern that the exemption of the first spouse to die will be under-utilized or wasted in its entirety for federal purposes.
2. However, the benefits of "portability" are tempered by the fact that the 2010 Act changes are *not* permanent and expire December 31, 2012; different rules could apply in 2013, and/or the "portability" rule eliminated.
3. Under Tennessee law, only a $1 million inheritance tax exemption is available to each spouse, and there is no "portability" between spouses; thus the possibility that the Tennessee exemption of the first spouse to die may not be fully utilized remains a concern.

With these considerations in mind, the discussion below describes two strategies in light of the 2010 Act changes.

Estate Tax Deferral

The objective of this strategy is to avoid all estate taxes upon the death of the first spouse, and defer taxes until the surviving death of the surviving spouse. Utilized in the extreme, one could leave all of one's property to the surviving spouse tax-free under the unlimited marital deduction. Under this scenario, assets passing tax-free would be "stacked" in the estate of the surviving spouse, and taxed in the estate of the survivor. At least in 2011 and 2012, from a federal estate tax perspective, no increase in federal estate taxes results because the full combined $10 million federal exemption is available to the surviving spouse. However, from a Tennessee inheritance tax perspective, such a plan merely defers but does not avoid Tennessee tax that need not be paid, because the $1 million Tennessee exemption *of the first spouse to die* is wasted.

Utilization of a Family Trust (in the Estate of the First Spouse to Die)

Rather than complete deferral of tax by leaving all assets outright to the surviving spouse under the marital deduction, prior to the 2010 Act a common estate planning strategy was to establish a Family Trust in an amount up to the amount of the federal exemption under the Will of the first spouse to die. This strategy assured that the federal exemption available to the first spouse to die was utilized, so that the maximum amount was left to beneficiaries utilizing the exemptions *available to each spouse.* Now that the unused federal exemption of the first spouse to die is available to the surviving spouse (at least in 2011 and 2012), there is less concern about under-utilization of the exemption of the first spouse to die to shelter assets from tax – at the federal level.

However, establishment of a Family Trust in the estate of the first spouse to die is still a viable and useful strategy to achieve the following tax and non-tax objectives:

- to assure full utilization of the $1 million Tennessee exemption of the first spouse to die (remember that "portability" of the unused exemption between spouses only applies with respect to federal estate taxes)
- to provide professional investment management and asset protection for the surviving spouse for his/her life
- to shelter *appreciation in value* of the assets and accumulated income held in the Family Trust from federal estate and Tennessee inheritance tax
- to assure that assets pass to heirs of the first spouse to die, rather than perhaps being redirected by the surviving spouse in cases of blended families or remarriage
- if gifts to grandchildren are desired, to utilize the generation-skipping tax exemption of the first spouse to die (which is also $5 million but *not* "portable" between spouses)
- if the law changes in 2013 so that the federal exemption is no longer "portable" between spouses, a Family Trust assures the federal exemption of the first spouse

to die is not wasted.

If necessary to provide for the support of the surviving spouse during his or her lifetime, the surviving spouse can be given the following rights over property placed in a Family Trust:

(1) income from the trust for life;

(2) the power to withdraw principal subject to use for health, maintenance, support or education;

(3) the power to withdraw principal to the extent of the greater of $5,000 or 5% of the corpus each year; and

(4) the power to appoint the property to specific beneficiaries.

In addition, an independent trustee may be given broader discretion to pay principal for the benefit of the surviving spouse.

Thus, this strategy suggests that a Family Trust funded in an amount *at least equal to* Tennessee exemption should be established in the estate of the first spouse to die. A second Family Trust share could be funded in an amount *up to* the $5 million federal exemption (or a lesser amount) if necessary to achieve any of the non-tax objectives identified above.

The remainder of the estate of the first spouse to die could be left outright (or in trust) for the surviving spouse, taking advantage of the unlimited marital deduction. The entire estate would thus pass tax-free at the death of the first spouse to die. At the death of the surviving spouse, (1) the Family Trust established under the Will of the first spouse to die passes tax-free to the heirs of the first spouse to die, and (2) only the amount exceeding the combined federal exemptions would be subject to federal estate tax in the estate of the surviving spouse (in 2011-12).

Tax-Free Lifetime Giving Opportunities

A program of lifetime giving to heirs removes assets and future appreciation from the taxable estate of the donor. With the federal gift tax lifetime exemption increased in 2011 and 2012 to $5 million, a two year window of opportunity exists to make lifetime gifts to heirs free of federal taxes. Such gifts might be made to remove future appreciation of assets that would otherwise be includible in the taxable estate. However, because there is no Tennessee gift tax lifetime exemption, such gifts will incur Tennessee gift tax to the extent the annual gift tax exclusion (discussed below) is exceeded. Further, a gift results in the recipient taking a “carryover basis” in the gift for income tax purposes upon a subsequent sale of the gift asset – so that future income tax payable on the sale will be measured by reference to the donor’s cost basis. This must be considered whether a gift or a disposition at death (with a stepped-up basis at the date of death value applying to future sales) is more tax efficient.

Individuals can make tax-free gifts up to $13,000 per recipient per year (increased to $26,000 per recipient per year for gifts made jointly by spouses). This annual exclusion renews each year; up to $13,000 per recipient can be given away year after year. Because gift property is removed from the estate of the donor, gifts of assets that are appreciating in value are particularly effective from an estate planning standpoint.

In addition to the $13,000 annual exclusion, (1) tuition payments made on behalf of any person directly to the educational institution, and (2) medical payments paid directly to the provider of medical services, are not subject to gift taxes.

Gifts to minors can be made outright, by means of custodial accounts or, subject to special requirements, in trust.

Federal Tax Advice Requirements

The IRS has issued requirements governing the rendering of written tax advice concerning federal tax issues. In compliance with those requirements, the advice concerning federal tax matters set forth herein is not intended or written to be used, and cannot be used, for the purpose of (1) avoiding penalties under federal tax law, (2) the advice was written to support the promotion or marketing of the matters or transactions addressed herein, and (3) you should seek advice based on your particular circumstances from an independent tax advisor.

Please contact Chris Was or a member of the Estate Planning and Administration Practice Group if you have any questions regarding these changes.

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