LOEB & LOEB LLP

Tax Law

ALERT

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Estate Planning Changes, Opportunities, and Pitfalls in the New Tax Law

It is rare that Congress and the President unite on a bipartisan basis to pass a tax law that provides estate tax relief. Rarer still is a tax law that provides significant lifetime planning opportunities in addition to the benefits available to decedents' estates. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act" for short) is such a rarity, and its changes warrant a fresh look at your estate plan.

This Tax Law Alert focuses on (a) the basics of the 2010 Tax Act, (b) some of the key lifetime planning opportunities afforded by the 2010 Tax Act, and (c) certain immediate action items that may be required to adjust existing estate plans to account for the 2010 Tax Act.

Summary

In its most basic terms, the 2010 Tax Act increased the exemptions from the "transfer taxes" and lowered the rates on such transfers. The higher exemptions and lower rates make these transfers more affordable.

1. **What are Transfer Taxes?** Under federal tax law, transfers of assets, whether from (a) a donor by a lifetime gift, or (b) a decedent by a bequest, are subject to tax. To allow individuals to transfer some wealth to children and other beneficiaries without paying a transfer tax, the law provides for exemptions from such taxes.

2. **Increased Exemptions.** The 2010 Tax Act (a) increased those exemptions significantly and (b) lowered the tax rates on transfers above the exemptions. The increased exemptions/lower rates of the 2010 Tax Act can be summarized as follows:

   - **Estate Tax Exemption.** For 2011 and 2012, the estate tax exemption is set at $5,000,000, with a flat 35% tax rate on assets above the exemption. In general, this means that the estate of an individual dying in 2011 or 2012, with assets having a net value of $5,000,000 or less, will not owe any estate tax.
   - **Gift Tax Exemption.** Linked to the estate tax exemption, the gift tax exemption is set at $5,000,000, with a flat 35% tax rate on gifts above the exemption. In general, this means that an individual can transfer $5,000,000 worth of assets over his or her lifetime by gift and not owe a gift tax. Use of the gift tax exemption reduces the estate tax exemption available at death on a dollar for dollar basis.
   - **Generation Skipping Transfer ("GST") Tax.** There is an additional tax on transfers to grandchildren and more remote descendants (the "GST tax").[1] The exemption from the GST tax on such transfers is set at $5,000,000. There is a 35% tax rate on such transfers in excess of $5,000,000. This exemption allows individuals to make transfers to grandchildren (or other more remote descendants) of up to $5,000,000 without incurring the additional (i.e., in addition to the estate or gift tax) GST tax.

[1] The GST Tax also applies to transfers to non-relatives more than 37½ years younger than the person making the gift or bequest.

3. **Temporary Increases.** Although the increases are good news for taxpayers, the bad news is that the increases are only temporary. The 2010 Tax Act applies in years 2011 and 2012.[2] Under current law, on January 1, 2013, the exemptions from estate, gift, and GST tax will be reduced to $1,000,000 (in the case of the GST tax, the amount of the exemption is unclear because it is inflation adjusted, and could be as much as $1,400,000). The tax rate on transfers above the $1,000,000 exemption will increase to 55%. Of course, this change back to lower exemptions and higher tax rates could be affected by further action by Congress and the President.

4. **"Portability."** Another important change in the 2010 Tax Act is the concept of portability (meaning the ability to transfer) of the estate tax exemption from a deceased spouse to a surviving spouse. This change means that estate planning for some married couples may be simplified.

In the past, to take full advantage of the deceased spouse's estate tax exemption, a separate, irrevocable "bypass" trust had to be established at the first death. The surviving spouse (or trustee) was required to allocate assets to the bypass trust, abide by the sometimes restrictive terms of such a trust, and file separate annual income tax returns for the bypass trust from and after the first spouse's death. All of this was necessary to avoid "wasting" the deceased spouse's estate tax exemption.

Under the 2010 Tax Act, the surviving spouse may elect to take the deceased spouse's unused exemption, and use it at his or her subsequent death, thus avoiding the necessity of a bypass trust. Nevertheless, there are important advantages to the continued use of a bypass trust, including the exclusion of all appreciation on assets held in a bypass trust from the surviving spouse's taxable estate and creditor protection. This topic should be discussed with estate planning counsel, because reliance on portability depends on the specific circumstances of each estate plan, and bypass trusts may still be desirable for families seeking to ensure minimization of estate taxes and attain the other benefits of holding assets in trust.

5. **Planning Opportunities.** The $5,000,000 exemption is particularly significant with respect to the gift tax, because the prior year's exemption from gift tax was only $1,000,000. As a result of this increase, there are significantly greater opportunities to shift assets to children and others without incurring a gift tax (as discussed below). Such gifts can remove appreciating assets from being subject to eventual estate tax in the donor's estate, thereby substantially reducing that tax.

6. **Recap of Exemptions.** The table below shows the progression of the increases and decreases in the estate tax exemption, gift tax exemption, and GST tax exemption for the period from 2009 through 2013.

Type of Transfer Tax	2009 Exemption and Rate	2010 Exemption and Rate	2011-12[3] Exemption and Rate	2013 Exemption and Rate
Gift Tax	$1,000,000 exemption and 45% rate	$1,000,000 exemption and 35% rate	$5,000,000 exemption and 35% rate	$1,000,000 exemption and 55% rate
Estate Tax	$3,500,000 exemption and 45% rate	$5,000,000 exemption and 35% rate[4]	$5,000,000 exemption and 35% rate	$1,000,000 exemption and 55% rate
GST Tax	$3,500,000 exemption and 45% rate	$5,000,000 exemption and 35% rate	$5,000,000 exemption and 35% rate	$1,400,000[5] exemption and 55% rate

7. **General Comments.** The 2010 Tax Act's increased exemptions and other changes have several effects

   - First, many more estates will avoid the estate tax entirely because of the $5,000,000 estate tax exemption. It is currently estimated that fewer than 0.2% of all 2011 decedents' estates will owe an estate tax.
   - Second, individuals should consider taking advantage of the increased gift tax exemption to transfer assets to their beneficiaries during lifetime. In general, gifts are a more tax efficient means of transferring assets than leaving them by way of inheritance.
   - Third, the increased exemptions may distort an estate plan in ways that disadvantage the intended primary beneficiary or beneficiaries. As discussed below, this is because many estate planning documents link the manner of transfer of assets to the "estate tax exemption" as a technically defined term. When the exemption increases, many estate plans require that the value of assets transferred to certain beneficiaries increase to track the increase in

[2] The 2012 exemptions will be adjusted for inflation, but that will likely be a modest adjustment.

[3] The exemption amounts for 2012 are indexed for inflation.

[4] Executors of 2010 estates can choose to elect into the "no estate tax/modified carry over basis" rule that existed under the old tax law.

[5] This is an estimate based on probable inflation adjustments.

exemption. This may leave other beneficiaries (such as the surviving spouse), who are to receive the balance of the assets, with significantly less assets than anticipated. This risk can be avoided only by reviewing your estate plan in light of the 2010 Tax Act.

Planning Opportunities

1. **Take Advantage of the Opportunity to Make Lifetime Gifts.** In past years, the ability to transfer assets to children (or other beneficiaries) during the donor's lifetime was limited because the maximum gift tax exemption was set at $1,000,000. Even with assets at depressed values due to the economic recession, taxpayers could not make large transfers by gift without incurring a gift tax of 45% of the value of the gift over $1,000,000.

For gifts made in 2011 and 2012, up to $5,000,000 of such transfers are exempt from tax. The gift tax exemption is a "cumulative" exemption up to the prior $1,000,000 exemption amount , and large gifts (i.e., those in excess of the $13,000 annual exclusion and non-taxable medical/tuition gifts) made in prior years count against the $5,000,000 exemption. The gift tax exemption is also unified with the estate tax exemption, so that gifts that use the gift tax exemption count against (i.e., they "use up") the estate tax exemption.

- **Example.** Assume that in 2009, a donor transferred assets to his children having a value of $1,000,000. Beginning in 2011, the donor can transfer an additional $4,000,000 to his children without incurring a gift tax. This is because the increase in exemption from $1,000,000 to $5,000,000 gives the donor additional "room" in the gift tax exemption to make tax-free gifts. Note that even if a donor made prior taxable gifts in excess of $1,000,000 and paid gift tax, the increased exemption is available.
- **Example.** Assume this same donor, in 2011, gives an additional $3,400,000 in assets to trusts for his children. No gift tax would be due because the cumulative $4,400,000 transferred ($1,000,000 in 2009 and $3,400,000 in 2011, combined) is less than the $5,000,000 exemption. Because the gift tax exemption and estate tax exemption are "unified," upon the donor's death, the donor will have an estate tax exemption of only $600,000 ($5,000,000 less prior transfers).

2. **Advantages of Making Gifts.** Even though gifts made during lifetime reduce the estate tax exemption (so that the potential estate tax is increased), the post-transfer appreciation and income on the transferred assets will not be taxed at the donor's death (thereby saving estate tax).

This concept can be illustrated as follows: Assume a donor owns real property (or other assets) that the donor expects to appreciate in value. The current value of the real property is $3,000,000, and the balance of the donor's assets has a value of $8,000,000 (a total of $11,000,000). Assume that the real property appreciates in value to $6,000,000 by the time of the donor's death.

- **Example.** A simple example demonstrates the benefits of making gifts at no gift tax cost in 2011. The donor considers two options:
- **Option 1.** Make a gift of the real estate at a value of $3,000,000 in 2011, leaving the balance of the donor's assets subject to estate tax at 35% (over the remaining $2,000,000 in estate tax exemption).
- **Option 2.** Do nothing, leaving the balance of $14,000,000 (the increased value of $6,000,000 plus the remaining assets of $8,000,000) subject to estate tax at 35%.

	Option 1 Make Gift	Option 2 Do Nothing
Initial assets	$11,000,000	$11,000,000
Gift in 2011 at low value	$3,000,000	$0
Assets subject to estate tax	$11,000,000 ($8,000,000 of assets retained by the decedent, plus the $3,000,000 gift at date of gift value, excluding subsequent appreciation)	$14,000,000 ($14,000,000 of assets retained by the decedent)
Estate tax (.35 x assets subject to estate tax in excess of exemption)	$2,100,000 (.35 x $6,000,000)	$3,150,000 (.35 x $9,000,000)
Assets left to beneficiaries (assets subject to estate tax less estate tax, with the real estate at a value of $6,000,000 upon death)	$11,900,000	$10,850,000
Additional Assets to Beneficiaries	***$1,050,000***	

- By making a gift now, the $3,000,000 in future appreciation is not taxed at death (and the tax avoided, i.e., a 35% rate on this $3,000,000 – or $1,050,000 – is left to the beneficiaries instead of the U.S. Treasury).

3. **GST Tax Savings Opportunities.** A similar advantage is available for transfers that would otherwise be subject to the GST tax.

   - **Example.** Applying the same facts set forth above with regard to the gift of $3,000,000 of assets, the donor could make the gift to grandchildren in 2011 or 2012 and avoid GST tax on the $3,000,000 in future appreciation.

4. **Additional Planning Opportunity: Intra-Family Sales Of Appreciating Assets.** Both asset values and interest rates remain low. If gifts cannot be made without incurring gift tax because the size of the gift or because the donor cannot part with the entire value of the asset, sales can be made at the current low values and interest rates. Sales, if made at fair market value, are not gifts and do not consume the $5,000,000 exemption or cause gift taxes. However, just like a gift, any increase in value on the property sold is not included in the seller's estate. The seller's estate would only include the cash down payment, promissory note payments made (interest and principal), and the balance due on the promissory note, but not the assets (or their future appreciated value).

5. **Additional Planning Opportunity: Cancelling Existing Intra-Family Loans.** In the past, because of the relatively low $1,000,000 gift tax exemption, parents would often sell (rather than making a gift) assets to their children (or other beneficiaries) in return for a low interest promissory note. To the extent those notes remain outstanding, the forgiveness of such notes may be a good use of the increased exemption, and such forgiveness will not cause the borrower to incur taxable "cancellation of indebtedness income."

6. **Caution – Low Income Tax Basis Assets.** Before making a gift of assets, you should consult with your estate planning attorney or tax advisor. When you make a gift, your "income tax basis" in the asset is transferred to the recipient (this is called "carryover basis"). If the recipient needs to sell the asset, he or she may owe significant income taxes. In contrast, the income tax basis of assets received upon death is "stepped-up" to its fair market value, and the recipient would be able to sell the asset without owing significant income tax. In making a gift, you will need to carefully weigh (a) the benefit of removing the assets and future appreciation and income from the estate tax (at a rate of 35%) against (b) the cost of causing the recipient to owe income tax upon sale.

7. **Conclusion.** The 2010 Tax Act significantly increased the exemption from the gift tax. The increase in exemption may only be temporary. Now is the time to take advantage of planning opportunities that may expire in as soon as two years.

Unintended Consequences

1. **Increase in Exemption.** The technical term for the estate tax exemption is the "applicable exclusion amount". Under the tax law prior to 2001, this term was called the "unified credit". This technical term, which is used in many estate planning instruments, translates over recent years into very different amounts of assets that a taxpayer could leave free of estate tax. As the table below indicates, the applicable exclusion amount has increased from $600,000 to $5,000,000 since 1997.

Year of Death	Estate Tax Exemption
1997	$600,000
1998	$625,000
1999	$650,000
2000	$675,000
2001	$675,000
2002-2003	$1,000,000
2004-2005	$1,500,000
2006-2008	$2,000,000
2009	$3,500,000
2010[6]	$5,000,000
2011-2012[7]	$5,000,000

This increase in an amount governed by a technical tax term can create unexpected results in estate planning documents.

2. **Husband and Wife Estate Plan.** The primary unexpected result can arise in the context of a fairly typical estate plan created by a husband and wife. Assume that husband and wife each have children from prior marriages, and no children from their current marriage. They executed estate planning documents in 1997 when the applicable exclusion amount was $600,000 and their combined estates had a value of $6,000,000.

   Their estate planning lawyer explained to them that upon the death of the first of them to die, they should try to

[6] Estates of decedents dying in 2010 can "opt out" of the estate tax and the exemption is unlimited.

[7] The exemption will be adjusted for inflation in 2012.

avoid or defer the payment of any estate tax. To do so, the husband and wife executed a fairly standard estate plan involving a bypass trust and survivor's trust (sometimes called an A/B Trust plan). Assuming that the $6,000,000 estate was entirely community property, then upon the first spouse's death, that spouse's share was $3,000,000 (one-half of the total $6,000,000), and the survivor's share was the remaining $3,000,000.

The husband and wife agreed that each of them would leave as much of their respective assets to his or her children at the first spouse's death, so long as this could be done without causing an estate tax in that estate.

The attorney explained that the most the first spouse could leave to his or her children would be the "estate tax exemption" ($600,000 in 1997 when the estate planning documents were signed). This amount could be set aside in a "bypass trust", a trust that solely for the deceased spouse's children (and not the surviving spouse). This bypass trust could be held in trust for such children or distributed outright, but regardless of the terms of distribution, the deceased spouse's children would benefit from the that spouse's assets upon his or her death. They would not have to wait until the death of the surviving spouse.

To defer the estate tax until the surviving spouse's death, the lawyer explained that the remaining $2,400,000 of the first spouse's share could be given to the surviving spouse or placed in trust for her benefit (in a "survivor's trust" that the survivor could revoke or amend, or in an irrevocable marital trust). The remaining $2,400,000 would be deductible for estate tax purposes so that upon the deceased spouse's death, by reason of the (a) $600,000 estate tax exemption and (b) $2,400,000 estate tax marital deduction, no estate tax would be due.

- **Illustration with 1997 Exemption.** The result of the plan upon the deceased spouse's death in 1997 would be as follows:
  - **Assets for Deceased Spouse's Children of $600,000.** This represents 10% of the couple's assets.
  - **Assets for Benefit of Surviving Spouse of $5,400,000.** The surviving spouse would benefit from the balance of the couple's assets, namely, assets having a value of $5,400,000. This represents 90% of the couple's assets. The plan makes a significant ($600,000) gift to the deceased spouse's children, and provides $5,400,000 for the surviving spouse's financial security.
- **Illustration with 2011 Exemption.** Assuming no change in the estate planning documents signed in 1997, the result is very different if the first spouse were to die in 2011. Assuming the value of the assets remained at $6,000,000, the estate plan would require the following allocations.
  - **Assets for Deceased Spouse's Children: $3,000,000.** The bypass trust for the deceased spouse's children would receive assets of the deceased spouse equal in value to the deceased spouse's estate tax exemption (i.e., $5,000,000), but limited to the amount of the deceased spouse's community property share of the assets ($3,000,000). In effect, the bypass trust would receive the deceased spouse's entire share of the community property estate, or $3,000,000 (five times the amount in 1997).
  - **Assets for Surviving Spouse: $3,000,000.** The surviving spouse would retain that spouse's one-half share of the community property, but would receive no part of the deceased spouse's share – an unexpected result due to 1997 estate planning documents being applied under 2011 law. This may not only be insufficient for the surviving spouse's support, it could require a sale of the family home!
- **Fixing the Problem.** Many estate planning documents use the technical "estate tax exemption" term to allocate assets equal to the estate tax exemption. The benefit of using the technical term is that the documents do not need to be amended as the exemption changes. The problem is that the estate planning documents usually do not put a "ceiling" on the maximum amount that passes to the recipients of the exemption. To fix this problem, an amendment to existing estate plans would be necessary. Such an amendment might "cap" the amount of assets passing to children at some fraction of the couple's assets or a fixed amount, or might provide that the surviving spouse receives support from the bypass trust if his or her own assets are insufficient.

2. **Generation-Skipping Transfers.** A similar unexpected result can arise in the context of an estate plan that benefits both grandchildren and children. Because the exemption from the GST tax has increased to $5,000,000, a gift to grandchildren equal to the GST tax exemption amount, with the balance left to children, may operate in a manner that was not intended. An estate plan drafted as recently as 1997, when the GST tax exemption was $1,000,000, would leave a relatively small fraction of the estate to grandchildren. The balance, presumably comprising the majority of the estate, would be distributed to children. However, in 2011, the same estate planning documents would leave $5,000,000 (the amount of the 2011 GST tax exemption) to grandchildren, leaving significantly less to children than expected. Again, to avoid this result, the estate plan should be amended to limit the gift to grandchildren, regardless of the amount of the GST tax exemption.

3. **Addressing Unexpected Consequences.** We urge our clients to review their estate plans every few years. The 2010 Tax Act makes such a review particularly timely. Estate planning documents, unfortunately, must rely on technical terms to deal with changes in the law. The 2010 Tax Act made historic and unexpected changes to those technical terms, and the possible effects on your estate plan make it imperative for you to review your estate planning documents with your estate planning counsel.

Conclusion

The last few years have seen unprecedented events in the national economy. At the same time, the 2010 Tax Act implemented historic and unforeseen changes in the law. The good news is that the 2010 Tax Act will benefit taxpayers and provide perhaps once in a lifetime estate planning opportunities. However, along with its benefits, the 2010 Tax Act can result in unintended adverse consequences. We urge you to revisit your estate plan to ensure that you are taking the right actions to benefit your beneficiaries in the manner you intend.

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