

Breaking Developments in Trusts and Estates Law

2010 Tax Relief Act

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On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Tax Relief Act”). The 2010 Tax Relief Act included a number of taxpayer-friendly changes to federal income, gift, estate and generation-skipping transfer taxes. This discussion focuses on the changes to the estate, gift and generation-skipping transfer taxes enacted as part of the 2010 Tax Relief Act.

Estate Tax Changes

Each person dying during the two-year period between January 1, 2011, and December 31, 2012, will have an available exemption to shield \$5 million in assets from federal estate tax. To the extent that the value of a taxpayer’s estate exceeds the \$5 million exemption, reduced by the taxpayer’s use of exemption during life, then such excess will be taxed at a rate of 35 percent.

Gift Tax Relief

During this two-year period, the highest federal gift tax rate will be 35 percent. In addition, each taxpayer will have a \$5 million gift tax exemption, reduced by the amount of exemption already utilized for prior lifetime gifts. In 2010, each taxpayer was limited to a \$1 million gift tax exemption. NOTE: The federal gift and estate tax exemption are unified. This means that an individual taxpayer has a single \$5 million exemption against federal estate and gift taxes that can be used either during life or at death.

Generation-Skipping Transfer Tax

A “generation-skipping transfer” (“GST”) is any gift between a grandparent and grandchild or more remote descendant. The GST tax applies to each GST at a 35 percent tax rate and the tax is in addition to gift and estate tax. Each taxpayer will have a separate \$5 million lifetime GST exemption, less any GST exemption previously used. The 2010 Tax Relief Act creates potentially significant planning opportunities and decisions for high net worth grandparents who are interested in passing wealth to grandchildren at the lowest currently available estate, gift and GST tax costs.

Portability of Estate Tax Exemption

The 2010 Tax Relief Act provides that for deaths in 2011 or 2012, the unused portion of the \$5 million estate tax exemption will pass to the decedent’s surviving spouse. The surviving spouse

can then use the decedent's unused exemption to shelter gift and estate transfers. For example, if a wife dies with a taxable estate of \$4 million, *i.e.* her estate does not fully use her \$5 million estate tax exemption, then the \$1 million unused portion of the wife's exemption passes to her husband. The husband would then have a total of \$6 million in gift/estate tax exemption to use against lifetime or testamentary transfers.

The portability of the exemption creates another option for married couples who would prefer not to utilize a "credit shelter" or similar trust to fully use the estate tax exemption of the first spouse to die. While some married couples will prefer to take advantage of the new exemption portability rule to avoid the creation of a credit shelter trust, the advantages offered by exemption portability must be reviewed in each case. There are a number of factors to consider, including that:

- A trust can protect trust assets from creditors of the beneficiaries;
- A trust can preserve assets for the decedent's descendants following the death of the surviving spouse;
- The new portability rules will expire by 2013 unless Congress acts;
- The appreciation in value of assets in a credit shelter trust is also sheltered from estate tax while the amount of the deceased spouse's exemption is fixed;
- The GST exemption is not portable; and
- The portable exemption can be lost through subsequent remarriage and death of a later spouse.

Sunset of 2010 Tax Relief Act

The gift, estate and GST provisions of the 2010 Tax Relief Act will expire on December 31, 2012. If Congress does not enact new legislation, the federal gift and estate tax laws will revert to the laws in effect in 2001. This means that the gift and estate tax exemption will be reduced to \$1 million per person, and the maximum gift and estate tax rate will return to 55 percent unless Congress acts. Likewise, the exemption for GSTs will return to \$1 million, adjusted for the inflation, and any excess GST will be taxed at 55 percent. The expiration of the 2010 Tax Relief Act at the end of 2012 complicates permanent estate planning because we cannot be certain that Congress will extend these provisions beyond 2012.

House Keeping and Planning Opportunities

1. Review Existing Estate Plans. It is important to re-examine existing estate plans to confirm that plan documents continue to accomplish the client's goals. The 2010 Tax Relief Act creates different planning opportunities for different clients. High net worth clients, *i.e.*, those who have assets well in excess of \$10 million per couple, may be most interested in their ability to make lifetime transfers using their \$10 million of gift tax exemption. On the other hand, couples with estates under \$5 million may be interested in discussing portability of the estate tax exemption.

2. Outright Gifts. The opportunity for a couple to transfer up to \$10 million free of gift tax should be attractive to many clients. The primary benefits of making a gift are to remove the future appreciation of the gift from federal estate tax and the value of the gift from Washington and Oregon State estate tax. The gift transaction could be structured in conjunction with a sale to a grantor trust to leverage the use of the \$5 million exemption.
3. GST Exemptions. The gift and sale transactions described above could be structured in combination with the generation-skipping trusts to remove the trust assets from future estate tax through allocation of the \$5 million GST exemption. The GST trust could be designed to benefit grandchildren immediately or to benefit the children for life and then for each successive generation.
4. Existing Loans to Children. Many clients have loaned money to their children. Clients may forgive up to \$5 million of existing debt free of gift tax.
5. Qualified Personal Residence Trusts (“QPRT”). Some clients own valuable residences, but the limited gift tax exemption under the old regime prevented them from taking advantage of a QPRT. With the new increased exemption, the transfer of a valuable residence to a QPRT can be an extremely efficient use of the \$5 million exemption given the current real estate market.
6. 2010 Deaths. The 2010 Tax Relief Act provided additional relief for taxpayers dying in 2010. The default rule for 2010 deaths is that the federal estate tax exemption and GST exemption are both \$5 million and the federal estate tax rate is 35 percent. Executors of the estates for 2010 decedents have the option to elect out of the default rule and to choose to apply federal zero percent estate and GST tax rates. If the executor makes this election, the estate will not receive a full basis step-up for its assets. For the wealthiest clients, this election could prove an extremely valuable tool to avoid federal estate tax. Of course, Washington and Oregon state estate tax will still apply to 2010 estates.

Because September 17, 2011, is Saturday, the extended due date for the federal estate tax is September 19, 2011, or no earlier than nine months from the date of enactment of the 2010 Tax Relief Act. However, both Washington and Oregon have announced that the due dates for each state’s respective estate tax returns have *not* been extended and remain due nine months from the decedent’s death.

Potential Consequences From Gifts

The expiration of the 2010 Tax Relief Act on December 31, 2012, creates the possibility that the estate tax exemption could revert to \$1 million per person and the gift and estate tax rates could return to 55 percent. It is possible that the tax savings inherent in the \$5 million exemption may be recaptured if the donor dies in 2013 or later when the federal estate tax exemption is \$1 million, or some other amount less than \$5 million. In other words, the donor's estate may have to pay estate tax on the difference between the \$5 million exemption and \$1 million exemption. The amount of tax “recaptured” from the donor's estate should be the same as if the taxpayer had retained the \$5 million, rather than making the gift.

One way for clients and their advisors to assess this risk is to understand that if a donor makes a \$5 million gift, the donor will, depending on whether the 2010 Tax Relief Act expires, is amended or is extended beyond 2012, either (1) never pay gift or estate tax on the gift, or (2) pay estate tax on the gift at his or her death. It is therefore critical that any gift plan address the possibility of the expiration of the 2010 Tax Relief Act, including the possibility that the tax savings from the \$5 million exemption may be recaptured at the death of the donor.

The two-year life span of the \$5 million exemption allows taxpayers a period of time to review and execute planning strategies. We recognize that many clients may choose to wait until late in 2012 to transfer substantial gifts. The “wait and see” approach is not without risk. The client will lose the chance to transfer any intervening appreciation tax free of the \$5 million gift. Any client who elects to defer the decision to make the \$5 million gift should be advised to include appropriate gift powers in his or her power of attorney or trust agreement to allow the completion of the gift if the client becomes incompetent. The client also could die unexpectedly, forfeiting the chance to transfer \$5 million in assets free of Washington and Oregon state estate tax.

For more information, please contact the Trust and Estate Practice Group at Lane Powell:

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