IS YOUR, OR YOUR CLIENT'S ESTATE PLAN UP TO DATE?

"On December 17, 2010, President Obama signed into law, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act"), settling some major questions about the federal estate, gift, and generation-skipping transfer tax law until December 31, 2012.

The Tax Relief Act makes the following changes to the federal estate and gift tax system:

- Estate Tax. The estate tax has returned with a larger exemption of $5 million and a lower tax rate of 35%.

- Gift Tax. The estate and gift tax exemption now are reunified, so that everyone now has a lifetime gift exclusion amount of $5 million per person and a 35% gift tax rate for gifts over $5 million.

- Exemption Portability Between Spouses: The Act provides for "portability" between spouses resulting in a maximum exemption of $10 million ($5 million per spouse) for a married couple. Portability allows a surviving spouse to elect to take advantage of the unused portion of the estate tax exemption of his or her predeceased spouse, thereby providing the surviving spouse with a larger exemption amount on their death. However, such portability is assured only for two years and the availability of this portable exemption amount requires an election to be made on a timely filed federal estate tax return.

- Generation Skipping Tax (GST). For transfers made in 2011, the GST exemption is $5 million, indexed for inflation beginning in 2012. The GST tax rate for 2011 and 2012 will be at a 35% tax rate.

- Option for 2010 Deaths. The Act gives estates the option to elect not to come under the returned estate tax. It gives those estates the option to elect to apply (1) the estate tax based on the new 35 percent top rate and $5 million exemption, with stepped-up basis (which eliminates the Massachusetts basis uncertainty) or (2) no estate tax and modified carryover basis rules. Any election would be revocable only with the consent of the IRS.

- Estate Planning Valuation Discounting Vehicles. The Act does not limit any existing estate planning discounting vehicles such as Grantor Retained Annuity Trusts (GRATs), Family Limited Partnerships (FLPs), which had been originally proposed by Congress.

Unfortunately, the changes effectuated by the Tax Relief Act are a temporary fix since they will be effective for only two years. Unless Congress takes further action within the next two years, at the end of 2012 there will be a reinstatement in 2013 of pre-2001 rates (55% for estates and lifetime gifts) and exemptions ($1 million for estate and gift taxes, and approximately $1.35 million for GST taxes). We expect that this problem will become a major issue in the 2012 presidential election.

Coincidentally, Massachusetts has revised its probate laws by recently adopting the Uniform Probate Code (“MAUPC”) resulting in major changes to guardianships, estates and trust laws. The provisions of the new probate code concerning guardianships and conservatorships became effective on July 1, 2009; however, the rest of the provisions of the code covering estates and trusts will become effective on July 1, 2011.

The Tax Relief Act creates several new planning opportunities that may only be available for the next two years. Therefore, we urge you to review your current estate plan and consider the following options before it is too late:

1. Take Advantage of the New Increased Gift Tax Exemption. You should consider making larger gifts in 2011 and 2012 due to the increase in the gift tax exemption to $5,000,000 in 2011 and the continuation of the 35% tax rate. Since the Tax Relief Act is temporary and only in effect for two years, it may be that the additional $4,000,000 lifetime exemption amount will only be available in 2011 and 2012. Therefore, you should begin to consider how to take advantage of this potential “use it or lose it” opportunity. In addition to this limited opportunity to transfer a significant amount of wealth tax-free it is still important to remember that you can still take advantage of the $13,000 per person per year gift tax annual exclusion for 2011 and 2012. Also, gifts of tuition payments and payment of medical expenses (if paid directly to the institutions) are still tax-free and can be made at any time. Predictions are that the largest transfer of wealth in our history will occur over the next two years.

2. New Massachusetts Planning Opportunity. Massachusetts estate tax returns are required and taxes paid only if the decedent’s estate has a value greater than $1 million at death (subject to lifetime gifts explained below). Although the $1 million is referred to as an exemption, it is not a true exemption but really only a filing threshold to file a Massachusetts estate tax return. For example, if your estate at death was valued at $1,000,001 you would end up being taxed on the total value of the estate and not just $1 over the exemption amount. This tax treatment did not change because of the Tax Relief Act nor is it likely to change in the near future.

Because Massachusetts has no gift tax, a lifetime gift (no matter the size) does not create a Massachusetts gift tax. There is a catch to this in that any lifetime gifts will reduce the Massachusetts $1 million exemption amount solely for the purposes of determining if a Massachusetts estate tax return will be required to be filed. However, even with this reduction in the exemption amount, lifetime gifting can still result in huge estate tax savings for Massachusetts. For example, assume a person has a $900,000 estate at death. If the person had made $1,500,000 of taxable gifts during his lifetime, the Filing Threshold would be reduced to zero because more than $1,000,000 was gifted during his lifetime.

Therefore, a Massachusetts estate tax return would need to be filed regardless of the amount of assets owned at the time of death. The estate would still be a $900,000 estate and the Massachusetts estate tax owed would be $27,600 (the Massachusetts estate tax on a $900,000 estate). If lifetime gifts had not been made, the taxable estate would have been $2,400,000 ($900,000 estate at death plus $1,500,000 of gifts), and the Massachusetts estate tax would have been $130,800 (the Massachusetts estate tax on a $2,400,000 estate). The lifetime gifts resulted in $103,200 of Massachusetts estate tax savings.

The Massachusetts estate tax savings are even greater with larger lifetime gifts. Therefore, large lifetime gifts will not eliminate your Massachusetts estate tax but will result in significant Massachusetts estate tax savings at no gift tax cost.

It is important to keep in mind that, although the federal estate tax law has changed, the Massachusetts estate tax law has not. Therefore, those of you who are not Florida residents, planning for a Massachusetts estate tax is still necessary.

3. Portability - Unused Exemption Amount. The Tax Relief Act creates a new concept of estate and gift tax exclusion amount called portability. Portability means that spouses, under certain circumstances, can share their unused $5 million estate and gift tax exclusion amount with each other. This portability allows spouses to effectively use a combined $10 million exemption. Again, portability only exists for the next two years and after that it is anyone’s guess. In prior years, a person's unused exclusion amount was not transferable to his or her surviving spouse. Starting in 2011, portability allows a surviving spouse to elect to use any exclusion unused by his or her deceased spouse in addition to his or her own $5 million exclusion. For example, if a husband dies in 2011, having made $2 million in lifetime gifts and leaving his entire $8 million estate to his wife, no tax is due at the husband's death, and an election is made on his estate tax return to allow his wife to use his $3 million unused estate tax exclusion. The wife's available exclusion amount is thereby increased to $8 million (her $5 million plus her husband's unused $3 million). Regardless of the size of the estate, an estate tax return for the decedent must be filed in order to make this election. There is no portability for any unused GST exemption.

This does not mean that we recommend our clients do away with the credit shelter/bypass trusts previously included in their estate plan. We still recommend that married couples continue to structure their estate plans to take full advantage of their estate and gift tax exemptions by using their credit shelter/bypass trusts and splitting ownership of their assets between themselves, there are several reasons for this:

- Appreciation of assets placed in the credit shelter/bypass trusts will escape estate taxation in the survivor’s estate;

- Creditor protection for credit shelter/bypass trusts and marital trust beneficiaries is achieved;

- Massachusetts does not recognize portability and credit shelter/bypass trusts will preserve the $1,000,000 Massachusetts estate tax exemption amount (this translates to a $99,400 estate tax savings for a married couple with a combined estate of $2 million);

- The GST tax exemption is not portable;

- Portability is dependent on the executor making an election to pass the remaining exemption amount to the surviving spouse and filing a timely estate tax return, that may not have otherwise been required. It could slip through the "cracks".

4. Use of Existing Gifting Techniques. Presently, conditions for gifting have never been better in modern times. Under the new law we have a $5 million unified estate, gift, and generation skipping exemption (indexed for inflation) and a 35% combined estate, gift and GST tax rate. Add to that, historically low federal interest rates, relatively low asset values and no legislation at this time restricting the use of various effective wealth transfer tools, such as the Grantor Retained Annuity Trusts (GRATs), Family Limited Partnerships (FLPs), Intentionally Defective Grantor Trusts (IDGTs), Generation Skipping Tax Trusts for Grandchildren and/or valuation discounts on family controlled enterprises. This means that these gifting techniques will not only continue to be highly effective planning tools but now will be even further enhanced due to the increased exemption amounts.

5. Charitable Planning. The charitable remainder trust (CRT), continues to be a valuable estate planning tool, especially in the current state of uncertainty. The CRT is generally used as an income tax planning vehicle, permits you to transfer appreciated property to a tax-exempt trust, which in turn sells the property and reinvests the proceeds and pays you an annuity or unitrust amount each year thereafter. This strategy also provides an estate tax deduction for the remainder interest passing to the charity when the trust ends.

6. Life Insurance. The Tax Relief Act does not change the role of life insurance in your estate plan. There are still many important reasons for life insurance other than just being used to pay potential federal estate taxes. For example, life insurance will still be needed to fund business buy-sell agreements; to serve as an income replacement for a spouse or dependents of a family's sole wage earner; as a means of leveraging annual exclusion gifts and providing liquidity to pay state estate taxes such as Massachusetts. Therefore, you should be careful about canceling or reducing your existing life

insurance coverage. For any clients that own a significant amount of life insurance, an irrevocable life insurance trust (ILIT) still remains an important planning technique to exclude life insurance proceeds from your gross estate. Remember, we do not know where we are two years from now and you might not be insurable then.

7. Non-Tax Reasons for Estate Planning. There are still many non-tax reasons why you should have your estate plan periodically reviewed and updated. At a minimum, you need to have documents in place that adequately address the following issues:

- Your circumstances have changed;

- If you become physically or mentally incapacitated during your lifetime, who will take care of your personal and health needs? Who will manage your assets?

- Who will receive your property at your death?

- Who will be in charge of your affairs after your death?

- Does your estate plan address how to handle property that will be inherited by beneficiaries that may have spending problems, special needs, substance abuse problems, divorce issue or just too young to receive a significant amount of property? Protecting beneficiaries in these situations will remain an important estate planning goal.

My Recommendation: The new developments in the estate, gift and GST tax and Massachusetts probate laws present an opportune time to consider and possibly take advantage of some of these valuable estate planning techniques that may not be as favorable in the future.

IRS CIRCULAR 230 NOTICE: