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Alert

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Important Estate, Gift and Generation-Skipping Provisions of the Tax Relief Act

Several December 31, 2010 Deadlines to Consider

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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Tax Relief Act) has now passed. This legislation presents estate planning opportunities far above and beyond any previously available. In 2010, before the passage of this law, you had to pass away to take advantage of the one-year repeal of the estate tax. The changes effected by the Tax Relief Act now place the focus on lifetime planning. Some of the planning opportunities will sunset on December 31, 2010, and require immediate action. Others become effective in 2011. The following summary is designed not only to give you an overview of the changes but also to put them in the context of planning options and opportunities.

Gift Tax Provisions

The "once in a lifetime" 35 percent federal gift tax rate for 2010 is now at least a "three year in a lifetime" 35 percent rate, not only for 2010 but also 2011 and 2012. The extension of the comparatively low 35 percent rates through 2012 are only part of the good news, however.

For 2010, the amount that can be gifted without incurring any federal gift tax liability remains up to $1 million, or $2 million if a husband and wife act in concert. For taxable gifts after 2010 and before 2013, these gift tax-free amounts will be "reunified" to parallel federal estate tax-free amounts, and will jump dramatically to $5 million (or $10 million for a married couple).

The favorable gift tax provisions included in the Tax Relief Act only extend through 2012. For gifts after 2012, the $1 million lifetime gift tax exclusion will again apply, and the marginal gift tax rates will be as high as 55 percent. Therefore, there is just more than a 24-month window of gifting opportunity afforded by the pending legislation.

Despite the discussions of various new limits on gifting during the past several years, no such limits are included in the Tax Relief Act. Grantor retained annuity trusts, including a term as short as two years and involving a *de minimis* or no taxable gift, continue to be permitted. There are no restrictions on discounting or other provisions aimed at curtailing the use of family limited partnerships or limited liability companies. Up to $13,000 (or $26,000 if a husband and wife act in concert) can be gifted annually to each child, to each grandchild, or to any other person, and none of these annual exclusion gifts will count against the lifetime federal gift tax exclusion amount of $1 million (or $2 million for a married couple) in 2010 or $5 million (or $10 million for a married couple) in 2011 or 2012. Healthcare and tuition expenses for children, grandchildren and others can continue to be paid directly without reducing the otherwise available $13,000 (or $26,000 for a married couple) annual exclusion gifts or lifetime federal gift tax exclusion of $1 million (or $2 million for a married couple) for 2010, or $5 million (or $10 million for a married couple) for 2011 or 2012.

Estate Tax Provisions for 2010

For a death in 2010, including a death in 2010 following passage of the Tax Relief Act, an estate can decide whichever of the two available alternatives is preferable:

1. By virtue of the default provision under the Act, there now is a $5 million federal estate tax exclusion, with a 35 percent federal estate tax rate to the extent the value of the taxable estate exceeds $5 million. For income tax purposes, the post-death tax basis of the assets includible in the taxable estate of the decedent would equal their respective values as of the date of death

(or possibly six months after that date). This default option may especially benefit an estate holding highly appreciated assets and having a net value of $5 million or less (or a higher level if a marital deduction is available).

2. Alternatively, an estate may elect to take advantage of the 2010 estate tax repeal provisions that were in effect before the passage of the Tax Relief Act. If this election is made by the executor, there would be no federal estate tax liability. For income tax purposes, the decedent's tax basis immediately before death would carry over and continue to apply after death, although a limited step-up in basis would be permitted for at least $1.3 million of appreciation during the decedent's lifetime. There is a further step up in basis of up to $3 million for transfers to or for the benefit of a surviving spouse, as well as additional adjustments for a decedent's net operating losses, capital loss carry forwards or year-of-death losses. As a general rule, this option would be preferable for large estates that might otherwise owe federal estate taxes.

Estates are given nine months from the date of enactment to file an estate tax return, or if they elect out of the estate tax regime, to file the Form 8939 (report regarding modified carryover basis). They also have the same extension to pay any estate tax due. In addition, beneficiaries will have the same nine-month period within which to file a disclaimer, although there may be compliance issues with state law or possible acceptance of benefit concerns.

Dilemma for Fiduciaries of 2010 Estates

Fiduciaries of 2010 estates are now faced with a dilemma in some instances of whether to make the carry over basis election. The decision needs to be based upon the specific facts of each estate and the provisions for its disposition. That decision may be impacted in those states that enacted "estate tax patch" legislation intended to provide meaning for typical tax formula provisions, such as "the maximum amount that may pass tax free," "the minimum amount [of marital deduction] needed to eliminate estate taxes" or "my remaining GST exemption." The issue may be whether the legislation in a particular state applies to all 2010 decedents in that state, or is to be viewed on an estate by estate basis, depending upon whether a particular estate has elected out of the estate tax for this year (which would mean that the estate tax did not apply to that estate).

Estate Tax Provisions for 2011 and 2012

For a death in 2011 or 2012, up to $5 million (plus a possible cost of living increase for a 2012 death) will be tax free for federal estate tax purposes. The federal estate tax rate for a taxable estate in excess of $5 million will be 35 percent. For income tax purposes, all assets includible in the taxable estate will have a tax basis equal to their respective date of death values (or possibly their values six months after the date of death). These 2011 and 2012 provisions thus parallel the provisions of the 2010 default rule.

The new law is not a permanent fix; it sunsets after 2012. If subsequent legislation is not enacted, the amount that could pass tax free for federal estate tax purposes will revert in 2013 to $1 million, and the highest marginal estate tax rate will be 60 percent, although the overall estate tax rate will not exceed 55 percent.

Generation-Skipping Tax Provisions

As under the law in effect before the Tax Relief Act's passage, no generation-skipping transfer tax is imposed on a 2010 generation-skipping transfer to or for the benefit of grandchildren or more remote descendants of the transferor or other beneficiaries who are two or more generations below the grantor. The zero generation-skipping tax rate applies even to 2010 generation-skipping transfers occurring after the passage of the Tax Relief Act. In addition, many of the questions that have persisted about 2010 gifts or other transfers to generation-skipping trusts have now been resolved in a manner that favors such transfers:

1. The potential drawbacks for 2010 gifts to annual exclusion gift trusts for grandchildren or other beneficiaries at least two generations below the donor have been removed.

2. Gifts to "dynasty" life insurance trusts which are intended to remain in existence for two or more generations can be made in 2010 in the same manner as in the past without threatening the exempt status of such trusts for generation-skipping tax purposes.

3. A so-called direct skip trust for grandchildren or more remote descendants can be created and funded in 2010 without incurring any generation-skipping tax liability at the time of the transfer. Moreover, if the donor elects out of the automatic allocation rules under IRC §2632(b)(3), this gift can be made without having to use any of the donor's otherwise available generation-skipping exemption, but only if the gift or other transfer is completed *no later than December 31, 2010*. Alternatively, the transfer can be made free of trust to the grandchild or other individual who is assigned to a generation at least two generations below the donor, but again the outright direct skip gift can be made without having to pay generation-skipping taxes and without having to use any of the donor's otherwise available generation-skipping exemption only if the transfer is completed *by December 31, 2010*, and the Section 2632(b)(3) election is made. *Time is therefore of the essence to take advantage of the last vestiges of no 2010 generation-skipping tax liability.*

The zero generation-skipping tax rate for 2010 is not the only good news on the generation-skipping front. For 2011 and 2012, the generation-skipping tax rate will be reduced from 55 percent to 35 percent. In addition, the generation-skipping tax exemption will be increased to $5 million (or $10 million if a husband and wife act in concert). This increase actually applies retroactively to January 1, 2010, and will remain in effect through 2012.

The Tax Relief Act greatly facilitates transfers to "dynasty" trusts exempt for generations, or even indefinitely, from generation-skipping tax. Both the generation-skipping tax changes and the gift tax changes favor "dynasty" trusts.

From a generation-skipping tax perspective, the generation-skipping tax exemption is increased to $5 million (or $10 million for a married couple). This $5 million (or $10 million) generation-skipping tax exemption is retroactively effective as of January 1, 2010, and will continue to apply through 2012. In contrast, the generation-skipping tax exemption was $3.5 million (or $7 million for a married couple) in 2009 and was not clear, but was probably zero, for 2010 before the passage of the Tax Relief Act.

From a gift tax perspective, the amount which can be transferred without incurring a federal gift tax remains $1 million (or $2 million for a married couple) for the balance of 2010, but it will jump to $5 million (or $10 million for a married couple) for 2011 and 2012. Although this lifetime federal gift tax exclusion may not exactly dovetail with the generation-skipping tax exemption during the 2011 and 2012 period – especially because certain annual exclusion gifts made to trusts will count against the generation-skipping tax exemption but not the lifetime federal gift tax exclusion – they will generally be at least approximately the same during the 2011 and 2012 period, and both, in tandem, will be materially higher starting in 2011 than they have ever been previously.

Because the increase in the lifetime federal gift tax exclusion does not take effect until 2011, such gift tax free and generation-skipping tax exempt transfers to a "dynasty" trust are probably best deferred until January 1, 2011 or later, but not beyond December 31, 2012, at least to the extent that a gift tax liability that would be incurred if the transfer was made in 2010 could be avoided by delaying the gift to 2011 or 2012.

For example, in January, 2011, a husband and wife who have previously made $2 million of taxable gifts, the maximum gift tax free amount through 2010, could make a gift tax free transfer of up to another $8 million to a "dynasty" trust that is for the benefit of children and more remote descendants and that could continue for generations, or even indefinitely under some state laws, without incurring any gift or generation-skipping tax liability. Even if the husband and wife have not previously made any taxable gifts and want to gift $10 million, it would be appropriate to wait until 2011 to make the gift. In contrast, a 2010 gift of $10 million would result in a $2.8 million federal gift tax liability on the $8 million portion of the $10 million gift that exceeds the $2 million lifetime federal gift tax exclusions of the husband and wife for 2010.

The combination of the much higher lifetime gift tax exclusion and the materially greater generation-skipping tax exemption present a dramatically expanded and enhanced planning opportunity that potentially would enable children as well as grandchildren and more remote descendants to benefit. Previously, the lifetime gift tax exclusion of $1 million (or $2 million for a married couple) has posed a material obstacle to making gifts that a wealthy individual might want to make to or for children and more remote descendants. The concern now may not be on the tax limits on gifting but instead may shift to whether even a wealthy individual wants to gift as much as the Tax Relief Act permits. Careful planning – such as including a spouse as well as children and more remote descendants as beneficiaries of the trust to which a substantial gift is made – may allay some, if not all, of these concerns. It is even possible under some state laws for the donor to make a large gift to a trust and to be a beneficiary of such trust, although trust distributions to the donor would not be assured and would be within the discretion of the trustee.

A very high net worth would-be donor who is especially close to his or her grandchildren may want to make a taxable gift above and beyond the available increased generation-skipping tax exemption and lifetime gift tax exclusion if the donor is willing to pay a substantial gift tax liability by reason of a gift to a "direct skip non-exempt trust" *on or before December 31, 2010*.

For example, assume that a very wealthy would-be donor wants to do more than just gift $10 million in January 2011 to a "dynasty" trust for his or her children, grandchildren and more remote descendants. The would-be donor would be willing to pay a 35 percent, or $3.5 million, gift tax liability by reason of an additional $10 million gift to a trust for grandchildren, but understandably would be very reluctant to pay on top of that gift tax liability a 35 percent generation-skipping tax liability by reason of the direct skip gift to the trust. The answer may be a $10 million gift *on or before December 31, 2010* to a "direct skip non-exempt trust" for the benefit of grandchildren, with a remainder interest to a trust for great grandchildren and more remote descendants after the death of the last living grandchild. It would even be possible for children to be added as trust beneficiaries several years after the trust's creation.

Even though none of the donor's generation-skipping exemption would be allocated to the trust, thus making it a non-exempt trust for generation-skipping tax purposes, the transfer to the trust would be a direct skip subject to a zero generation-skipping tax liability if it is completed *no later than December 31, 2010*. Subsequent distributions of income, principal, or both from the direct skip non-exempt trust to one or more of the grandchildren would not be subject to any generation-skipping tax liability, but a taxable termination and resulting generation-skipping tax liability would be triggered by the death of the last living grandchild.

It goes without saying that a direct skip non-exempt trust would not appeal to every very high net worth would-be donor. Not only would the would-be donor need to be willing to pay a very substantial gift tax liability, but he or she would also need to be comfortable setting up a large trust which bypasses children in favor of grandchildren, at least for a number of years. For a limited number of very high net worth individuals, however, the direct skip non-exempt trust may offer a once in a lifetime generation-skipping gift opportunity, but only if these select would-be donors move very quickly to beat the impending *December 31, 2010 deadline*. Even the payment of gift taxes may be an advantage and not a disadvantage, although this admittedly sounds counter-intuitive. A payment of gift taxes can result in substantial ultimate estate tax savings by removing the gift taxes paid from the donor's ultimate estate tax base, thus further enhancing the overall transfer tax benefits of a large 2010 gift to a direct skip non-exempt trust, if the donor lives for more than three years after the date of the gift to such a trust.

After 2012, pre-2001 law will again apply. The generation-skipping tax exemption will drop to about $1.4 million and the generation-skipping tax rate will revert to 55 percent, unless Congress acts in the interim. Thus, the only certainty we have is a two-year time frame within which to take advantage of any of these generation-skipping planning opportunities.

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John D. Dadakis concentrates his wealth planning practice on representing executives of Fortune 500 companies, successful entrepreneurs in private businesses, and managing directors and investors in hedge and private equity funds. As "Personal General Counsel" to an elite national client base, Mr. Dadakis develops and implements wealth preservation strategies that address the financial and social goals of those he serves. He is highly knowledgeable and experienced on the development and use of family mission statements and family constitutions. His Personal General Counsel model is uniquely suited to handle the needs of family- and closely-held business owners.

Milford B. "Mil" Hatcher Jr. handles all areas of U.S. tax law, including family limited partnerships, business succession and income tax planning, tax controversies, and partnership, corporate and transfer tax. He has specific knowledge regarding business-oriented estate planning and valuation and "freeze" planning, which is designed to shift appreciation in value to lower generations with minimal or no current gift tax liability.

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Additional resources

Estate Tax Will Return Next Year, but Few Will Pay It

New York Times, December 17, 2010

(Ed Koren quoted)

New Law Means Big Savings for Millions of Taxpayers

St. Petersburg Times, December 18, 2010

(Ed Koren and Bill Sherman quoted)

Estates Get Choice Between Carryover Basis or Estate Tax Under New Legislation

BNA Daily Tax Report, December 20, 2010

(Ed Koren, David Scott Sloan and Chris Boyett quoted)

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