

RING IN 2011 AND 2012 WITH THE NEW TAX LAW

The uncertainty we shared in our last Alert regarding tax rates and exemptions has temporarily subsided. On December 17, 2010, the President signed into law the “Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010” (“Act”), revising the income, estate, generation-skipping transfer (“GST”) and gift taxes for 2010, 2011 and 2012. This Alert provides a brief summary of the law and its possible impact.

Overview

For 2010, the Act retroactively imposed an estate tax at a 35% rate with a \$5 million exemption and a GST tax at a 0% rate with a \$5 million exemption. Also for 2010, the Act retained the gift tax rate of 35% with the lesser \$1 million exemption for lifetime transfers. As of January 1, 2011, the estate, GST, and gift tax rate is 35% with a unified \$5 million exemption.

An important component of the Act is that it provides for portability of the estate and gift tax exemption, but not for the GST exemption. This means that married couples

can take advantage of a combined “total” of \$10 million in gift and estate tax exemption, regardless of the manner in which they held their assets. Under this new rule, a surviving spouse may use any exemption amount not used by the first spouse to die. If the surviving spouse remarries, this equation may be affected based on the unique circumstances of each remarried couple; therefore, special assistance from your attorney is necessary. The formula for portability is:

\$5 million exemption of first spouse to die

Less exemption used by first spouse for lifetime gifts

Less exemption used by first spouse for gifts at death

Unused exemption of first spouse

Plus \$5 million exemption of surviving spouse

Less exemption already used by surviving spouse for lifetime gifts

Balance of exemption available for surviving spouse to use for lifetime gifts or gifts at death

	2010	2011–2012
Maximum Income Tax Rate	35%	35%
Maximum Capital Gain Rate	15%	15%
Gift Tax	\$1 million exemption Maximum rate: 35%	\$5 million exemption Maximum rate: 35%
Estate Tax	\$5 million exemption Maximum rate: 35% OR election to use carry-over basis regime and no estate tax	\$5 million exemption Maximum rate: 35%
GST Tax	\$5 million exemption Maximum rate: 0%	\$5 million exemption Maximum rate: 35%

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Gifts

Annual exclusion gifting is not affected by the Act. A maximum of \$13,000 may currently be gifted annually to an unlimited number of individuals without incurring a gift tax, and payments made directly to an educational institution for tuition costs or to a medical care provider for medical costs (including medical insurance) remain tax-free transfers. The annual exclusion amount is indexed for inflation and will continue to increase in \$1,000 increments.

The current 35% gift tax rate is extended into 2011 and 2012, and a \$5 million exemption per person is available for two years beginning January 1, 2011. Making gifts during lifetime, rather than transferring assets at death, provides the benefit of a low tax rate and a tax-free transfer of future appreciation (as well as avoiding an estate tax on the gift tax dollars if the donor survives by three years).

An earlier version of the Act sought to impose a minimum ten-year term on Grantor Retained Annuity Trusts (“GRATs”) and would have prohibited zeroed out GRATs (GRATs designed to incur no gift tax exposure). These limitations are absent from the final version of the Act; therefore, short-term zeroed out GRATs are still valuable avenues for transferring wealth, especially with the Section 7520 rate remaining low at only 2.4% for January 2011.

For estate planning purposes, individuals should keep in mind that the \$5 million unified exemption and 35% tax rate are effective only for 2011 and 2012. Without congressional action to extend these provisions, the exemption amount and rate will return to 2001 levels in 2013 — a \$1 million exemption and 55% tax rate. Also, lifetime gifts benefit from the tax exclusive nature of the gift tax versus the tax inclusive nature of the estate tax. The gift tax is based on only the amount transferred (not the funds used to pay the gift tax); whereas the taxable estate includes the amount of tax that is ultimately paid, meaning that the estate pays taxes on the funds used to pay the taxes. Finally, it is unknown whether the portability provisions will survive beyond 2012 in the case of a spouse who has died in 2011 or 2012. All of these factors make the next two years a particularly opportune time to make gifts.

Generation-Skipping Transfer (GST)

As of January 1, 2011, the GST tax rate is 35% with a GST exemption of \$5 million. Portability does not apply to the GST exemption; therefore, it is important for married couples to balance their assets between spouses to maximize

use of their individual GST exemptions. In addition, the increase of both the GST and gift tax exemptions to \$5 million means that individuals have more flexibility in deciding whether to create and fund trusts for grandchildren and future generations during their lifetime, especially during the next two years.

For individuals who made a GST gift in 2010, the Act retroactively imposed a GST tax with a rate of 0% and an exemption of \$5 million for any transfers made after January 1, 2010. It is critical that these individuals file a timely gift tax return that reflects an election to opt out of the automatic allocation of GST exemption. If an individual does not opt out of the automatic allocation rules on a timely filed return, the government will apply GST exemption dollars to the 2010 transfer that incurred no taxes under the 0% rate and the individual will have wasted GST exemption that could have been preserved to be allocated to future GST transfers subject to a higher tax.

Estate Tax

For individuals who died prior to December 17, 2010, the executor of the individual’s estate may elect to opt out of the Act and instead apply the prior 2010 law. If the election is made to opt out, there will be no estate or GST tax and property will receive a carryover (decedent’s) basis with the ability to step up the basis by an additional \$1.3 million (plus \$3 million for assets passing to or in trust for a spouse). If the election is not made, the estate will be taxed at the rate of 35% for amounts above the \$5 million exemption and the beneficiaries’ basis will be the fair market value of the property as of the date of death. The executor must file the applicable returns by September 17, 2011 (nine months after the date of enactment of the Act).

For 2011 and 2012, the estate tax rate is 35% and the estate tax exemption is \$5 million (less any portion of the exemption used during lifetime). Instead of reinstating the state death tax credit, Congress continued allowing estates to deduct state taxes paid, which does not provide for a dollar for dollar reduction at the federal level. In fact, for those states imposing an estate tax (e.g. New Jersey and New York), the cost of full utilization of the federal estate and GST exemption has become more expensive (the same impact does not occur for lifetime gifting making lifetime gifts more financially attractive). Married couples are encouraged to review their wills and other estate planning documents to make sure these documents still reflect their

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intentions in light of the increased exemption amounts and new portability rules.

Charitable Giving

Under the Act, individuals 70½ years of age or older may make tax-free IRA distributions to charitable organizations. The maximum distribution amount is \$100,000 per individual, per tax year. If an individual makes the distribution in January 2011, he or she may elect to apply the distribution to 2010. This essentially allows a distribution of up to \$200,000 to charity in 2011.

In addition, due to the historical low of both the Section 7520 rate and gift tax rate, it continues to be a great time for charitable lead trusts (“CLTs”). A CLT is a trust that makes a payment to a charitable organization for a set period of time. At the end of the trust term, the remaining assets are paid to one or more noncharitable beneficiaries, typically family members. The low Section 7520 rate causes the present value of the charity’s annuity to be higher, potentially allowing for a larger charitable deduction while decreasing the taxable gift to the non-charitable remainder beneficiaries.

Income Tax

Under the Act, the “Bush-Era Tax Cuts” continue through 2012 with a maximum income tax rate of 35% and a maximum long-term capital gains rate of 15%. Qualified dividends are taxed at the long-term capital gains rate. Itemized deductions and personal exemptions of high-income taxpayers are not reduced under an AGI phase-out and numerous deductions and credits are continued. Clients should check with their tax-preparer to review these continued deductions and credits to ensure the maximum benefit from these extensions. In addition, the AMT thresholds were increased for all taxpayers. For 2011, the thresholds are:

- Individual \$48,450,
- Married Filing Jointly \$74,450, and
- Married Filing Separately \$37,225.

Finally, for the tax year 2011 only, there will be a temporary 2% payroll social security tax cut for employees.

Concluding Reflection

Congress did not give taxpayers much time to benefit from the advantages this Act provides. Unless Congress acts by 2013, the estate, gift and GST tax exemption will drop to \$1 million and the tax rate will increase to 55%. Consequently, careful planning, and where appropriate, affirmative action during the next two years will be critical to meeting your planning goals. ♦

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This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking legal action.

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