

ESTATE TAX ASPECTS OF TRA 2010

By Michael Repak, JD, CPA, LL.M.

Vice President, Senior Estate Planner, Wealth Planning Department

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("TRA 2010"). TRA 2010 significantly changed the federal estate tax, which affects estate planning for many individuals. It presents significant estate planning opportunities.

This summary details TRA 2010's key changes and offers you some observations about TRA 2010's impact on estate planning.

Please note that there are important income tax changes made by TRA 2010 that this summary does not address.

SUMMARY OF KEY ESTATE AND GIFT TAX PROVISIONS OF TRA 2010

Estate Tax

Before TRA 2010, the federal estate tax was gradually reduced over several years and then eliminated for decedents dying in 2010. Prior law provided that the estate tax, with a maximum tax rate of 55% and a \$1 million applicable exclusion amount, would be reinstated after 2010. Additional changes scheduled for years after 2010 affected the gift and generation-skipping transfer ("GST") taxes.

TRA 2010 **retroactively** reinstates the estate tax for decedents dying during 2010, but at a significantly higher applicable exclusion amount of \$5 million, and a lower maximum tax rate of 35%, than under prior law. This estate tax model continues for decedents dying in 2011 and 2012. But, this new approach is itself temporary and will sunset on December 31, 2012. The prior estate tax regime, with a 55% maximum estate tax rate and a \$1 million applicable exclusion amount, could be reinstated at that time (2013) if Congress fails to act.

TRA 2010 also eliminated the modified carryover basis rules for 2010 and replaced them with the stepped-up basis rules that had applied before 2010. Property with a stepped-up basis generally receives a basis equal to the property's fair market value on the date of

the decedent's death. Under the modified carryover basis rules that applied during 2010 before TRA 2010, executors generally could increase the basis of estate property only by a total of \$1.3 million (plus an additional \$3 million for assets passing to a surviving spouse, for a total increase of \$4.3 million), with other estate property taking a carryover basis equal to the lesser of the decedent's basis or the property's fair market value on the decedent's death.

TRA 2010 allows estates of decedents dying during 2010 the option to apply either: (1) the estate tax based on the new 35% top rate and \$5 million applicable exclusion amount, with stepped-up basis, or (2) no estate tax and modified carryover basis rules under prior law.

TRA 2010 also introduced the concept of "portability" between spouses of the estate tax applicable exclusion amount for estates of decedents dying in 2011 and 2012, if both spouses die before 2013. Generally, portability allows surviving spouses to elect to take advantage of the unused portion of the estate tax applicable exclusion amount (but not any unused GST tax exemption) of their predeceased spouses, thereby providing surviving spouses with a larger exclusion amount. Special limits apply to decedents with multiple predeceased spouses.

To preserve the first deceased spouse's unused applicable exclusion amount, the executor for such spouse must file an estate tax return and make an election on such return, even if such an estate tax return would otherwise not be required.

Gift Taxes

For gifts made in 2010, the maximum gift tax rate was 35% and the applicable exclusion amount was \$1 million. For gifts made in 2011 and 2012, TRA 2010 limits the maximum gift tax rate to the same 35% but increases the applicable exclusion amount to \$5 million. As discussed below, this change provides an opportunity to transfer significant amounts of wealth free of estate and gift taxes.

Donors continue to be able to use the annual gift tax exclusion before having to use any part of their applicable exclusion amount. For 2010 and 2011, the annual exclusion amount is \$13,000 per donee (married

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couples may continue to “split” their gift and may make combined gifts of \$26,000 to each donee).

Generation Skipping Transfer (“GST”) Tax

TRA 2010 provided a \$5 million GST exemption amount for 2010 (equal to the applicable exclusion amount for estate tax purposes) with a GST tax rate of 0% for 2010. For transfers made after 2010, the GST tax rate would be equal to the highest estate and gift tax rate in effect for the year (35% for 2011 and 2012). TRA 2010 also extended certain technical provisions under prior law affecting the GST tax.

OBSERVATIONS REGARDING TRA 2010

General Observations

Generally, the estate and gift tax provisions of TRA 2010 are very favorable to taxpayers, because of the substantial increase in the applicable exclusion amount to \$5 million, and the lower maximum estate and gift tax rate of 35%. TRA 2010 also addresses several technical estate, gift and GST tax issues in a manner that is favorable to taxpayers (e.g., the impact of the lapse of the estate tax, including the application of basis rules, on decedents who passed away during 2010).

Temporary Fix

TRA 2010 is a temporary fix, which sunsets on December 31, 2012, immediately after the next election cycle. It is impossible to predict whether it will be extended in either its current or some modified form, especially given the fact that it is a hot button issue with both major political parties. If Congress fails to act, TRA 2010 will lapse and the estate tax will revert to what it would have been under prior law (i.e., \$1 million applicable exclusion amount and 55% maximum estate and gift tax rate).

Increased Gift Tax Applicable Exclusion Amount

From 2001-2010, the applicable exclusion amount for gift tax purposes was \$1 million. TRA 2010 increased this to \$5 million, or \$10 million per married couple for 2011 and 2012 (inflation-indexed). This change provides an unprecedented opportunity to move substantial amounts of wealth out of individuals’ estates. There are several techniques that individuals can use to leverage this \$5 million applicable exclusion amount, to move substantially more wealth out of their estates.

For example, the increased gift tax applicable exclusion amount increases the amount of assets that individuals can transfer by an installment sale to a dynasty/grantor trust. Under this estate planning technique, individuals can now make an initial gift of as much as \$5 million

(\$10 million per married couple) to a dynasty trust, and then transfer as much as \$45 million (\$90 million for a married couple) to such dynasty trust in exchange for an installment note. This technique works especially well for family businesses that are expected to grow significantly in value over time.

Given the fact that TRA 2010 will sunset without further Congressional action in 2012, individuals may consider implementing estate planning techniques utilizing lifetime gifts before the December 31, 2012 sunset date.

State Estate Taxes

Many states have separate estate tax regimes with lower applicable exclusion amounts than the federal applicable exclusion amount. These include the District of Columbia, Maryland, Massachusetts, New Jersey, New York, Pennsylvania and Rhode Island, among others. It is critical that the estate plans of individuals living in or owning property located in such states address such estate tax exposure.

It is possible that, due to the higher exclusion amount, additional states may change their tax laws, separate from the federal levels, in order to retain or enhance their revenue in the future.

Portability

One of the more notable provisions contained within TRA 2010 was the “portability” provision, which provides in general terms that if one spouse does not fully utilize his/her entire \$5 million applicable exclusion amount, the unused portion can be used by the surviving spouse’s estate. This provision is intended to avoid the need for bypass or credit shelter trusts in estate planning documents. Unfortunately, both spouses must die before 2013 in order to benefit from the portability provision.

In addition, credit shelter trusts continue to provide significant additional benefits beyond just the use of each spouse’s applicable exclusion amounts. These include the following:

- Ensuring that assets contained in the credit shelter trust pass to children of the couple and not to any new spouse of the surviving spouse.
- Ensuring that appreciation on the assets contained within the credit shelter trust, which may exceed the applicable exclusion amount at the surviving spouse’s death, are not subject to estate tax at that time.
- Protection of assets in the credit shelter trust from creditors of the surviving spouse, including any marital claims of future spouses.

Given the fact that the portability provision may sunset in 2012, as well as for the reasons stated above, individuals can consider continuing to use estate plans that incorporate credit shelter trusts.

What Did TRA 2010 Fail to Address?

There are two key provisions that many commentators thought would be in TRA 2010, but which were not included in it. Specifically, there have been several proposals to place limits on Grantor Retained Annuity Trusts (“GRATs”), which allow individuals to transfer wealth out of their estates with as little as a zero estate or gift tax cost, that would have made GRATs less valuable from an estate planning perspective. There have also been several proposals to limit valuation discounts in connection with certain estate planning techniques such as Family Limited Partnerships. There were no such provisions included in TRA 2010. Therefore, these techniques continue to be available to move wealth to lower generations.

SUMMARY

In conclusion, TRA 2010 made significant estate and gift tax changes. The key points discussed above include the following:

- The estate tax exclusion amount increases to \$5 million per person for 2010 through 2012.
- The maximum estate and gift tax rate is reduced from the 55% maximum rate under prior law to a maximum estate and gift tax rate of 35% for 2011 and 2012.
- A “portability” provision is included, which allows surviving spouses to use any applicable exclusion amount that is not used by the first spouse to pass away.
- The GST exemption amount is increased to \$5 million for 2010 through 2012.
- TRA 2010 sunsets at the end of 2012, thus making the foregoing changes temporary in nature.

As always, we recommend that clients review their estate plans periodically and/or whenever a significant life event occurs (e.g., birth of a child, death of a spouse, purchase of new home, etc.). Your Financial Advisor, together with Janney’s team of planning specialists, can assist you with a review or development of your estate and financial plan.

For individuals with substantial amounts of wealth and with closely held businesses, it may make sense to consider using lifetime gifts to take advantage of the current \$5 million lifetime gift tax applicable exclusion amount, which will expire absent further Congressional action at the end of 2012. Such individuals may find it especially useful to complete a financial plan as part of this process to determine how much they could safely give to younger family members.

Please contact your Janney Financial Advisor with any questions you may have or if you would like to discuss an estate plan in light of TRA 2010.

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