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Estate and Gift Tax Planning In the Whole New World of 2011 – 2012

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Major changes to the estate, gift, and generation-skipping transfer taxes were enacted on December 17, 2010, as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act"). The 2010 Act brought certainty (up to a point) to the federal transfer tax system, after a decade of exemptions and rates that were moving targets. Once again, however, Congress gave us short-term law: the provisions, described below, sunset at the end of 2012.

Changes to the Transfer Tax System for 2011 – 2012

$5 Million "Re-unified" Estate and Gift Tax Exemption Amount

The 2010 Act reunified the estate and gift tax exemption at $5 million, a major increase over prior law. This reunification means that up to $5 million of lifetime gifts (that do not qualify for other exclusions or exemptions) are exempt from gift tax. Any portion of the exemption not used during life is available as an exemption from estate tax, at death.

The gift tax exemption had been $1 million for many years. Gifts sheltered by the prior $1 million exemption now count against the current $5 million exemption. In other words, if you previously made $1 million of gifts sheltered by the $1 million gift exemption, the 2010 Act gives you an additional $4 million exemption.

In 2001, the estate tax exemption was $1 million (reduced by lifetime gifts of up to $1 million). The estate tax exemption gradually phased up during the last decade, however, reaching $3.5 million in 2009, before the one year (2010) of repeal. The repeal for 2010 decedents is now elective, as described further below.

Under the 2010 Act, the top estate and gift tax rate for 2010 – 2012 is 35% (effectively a flat rate on gifts and estates that exceed $5 million), down from 45% in 2009 and 55% before 2001.

Basis Step-Up

The estate tax goes hand-in-hand with the "basis step-up" rule. Under this rule, a decedent's assets pass to his or her heirs with a basis (cost) for income tax purposes equal to fair market value on the date of death. By contrast, the donee of a lifetime gift receives the gifted asset with the donor's basis (the "carryover basis" rule). For highly appreciated assets, and particularly for any asset subject to a liability in excess of its basis, the basis step-up may be worth more than the estate tax savings of excluding the asset from the donor's estate.

Special Rules for 2010 Decedents
Prior to the 2010 Act, the estate tax was repealed for 2010 (only) and the carryover basis rule applied to assets inherited from a decedent who died in 2010 (a "2010 decedent"). The 2010 Act repealed the repeal of the federal estate tax, thereby reinstating it retroactively, to apply to all 2010 decedents. However, the estate of a 2010 decedent may elect out of the estate tax and be subject, instead, to the law of repeal: no federal estate tax (no matter how large the estate) and carryover basis, except for two limited basis increase amounts. A basis increase of $1.3 million may be allocated among the decedent's assets generally; an additional basis increase of $3 million may be allocated to assets passing to the decedent's spouse outright or in certain qualifying trusts. The basis of an asset may not be increased above fair market value, however. Also, if the decedent owned an asset with a basis higher than its value, the basis will be "stepped-down" to fair market value at death.

Generation-Skipping Transfer Tax
The generation-skipping transfer tax ("GST") also was amended by the 2010 Act. The GST exemption amount is increased to $5 million, available to shelter generation-skipping transfers during life and, to the extent unused during life, at death. The GST tax rate was 0% (!) for 2010 and is 35% for 2011-2012.

Inflation Adjustment
In 2012, the estate, gift, and GST exemption amounts (each increased to $5 million as described above) will be adjusted for inflation. Absent further legislative change, the inflation adjustment lasts for just one year (2012), under the sunset provision described below.

Portability of Exemption
Under the 2010 Act, if a taxpayer who dies after 2010 has less than $5 million of assets, his surviving spouse may add to her exemption the unused portion of the deceased spouse's exemption. This "portability" rule applies only to the decedent's unused estate tax exemption (not GST exemption) and it applies only to decedents dying in 2011 or 2012. Under the law as now in effect, you may not increase your exemption by your spouse's unused exemption amount if your spouse died before 2011, and you will not benefit from your spouse's unused exemption if your spouse dies in 2011 or 2012, unless you use it through lifetime gifts during 2011 or 2012, or die in one of those years.

Sunset
The 2010 Act provisions described above apply only to 2011 and 2012. Beginning January 1, 2013, absent further legislative action, the law reverts to its pre-2001 status:

- $1 million unified gift and estate tax exemption amount
- $1 million GST exemption amount (the GST exemption is adjusted for inflation)
- 55% top rate
- No inflation adjustment for gift or estate tax exemption
- No portability

Assorted other rules from pre-2001 law also return, most notably, the credit for state death taxes.

Planning Considerations

Need to Review Your Will

Given the significant increase in the exemption amounts, it is advisable to review your Will and estate plan to determine how they will work under the 2010 Act. For example, if your Will uses a formula tied to the federal estate tax exemption amount to determine how much of your estate passes to your spouse, the spouse may receive less (or more) than you intended, if you die at a time when the exemption amount is $5 million.

Take Advantage of the Opportunities for 2011-2012

The 2010 Act provides a tremendous opportunity for gifting transactions during 2011 and 2012, with the potential to save a very significant amount of estate tax. There are a number of reasons to take as much advantage as possible of the increased exemption amounts during this 2-year window.

First, the exemption amounts revert to $1 million in 2013, absent a further change in law. There is no guarantee that Congress will act to prevent the exemptions from returning to the $1 million level.

Second, it would be unwise to count on portability between spouses, by "saving" exemption for use by the second-to-die spouse's estate. As noted above, portability works under the 2010 Act only if both spouses die during 2011 and/or 2012. Furthermore, there is no portability for GST purposes and, absent a change in applicable state estate tax law, there is no portability for state estate tax purposes. Thus, you need all the provisions in your Will that you have always needed to ensure that the exemption amount of the first-spouse-to-die is captured and not wasted.

Third, in states like New York, which has an estate tax but no gift tax, the lifetime gift means that New York tax will be entirely eliminated with respect to the gifted asset. Furthermore, if the gifted asset appreciates after the date of the gift and before the donor's death, that appreciation escapes federal and state transfer tax.

There are some disadvantages to gifts, compared with retaining the asset for inclusion in the donor's estate for estate tax purposes. As noted above, the donee of a lifetime gift succeeds to the donor's basis (carryover basis), thereby preserving the inherent gain in an appreciated asset for later income taxation in the hands of the donee. An asset likely to be sold in the near future may not be the right asset for a gift, since it is generally more efficient for the donor to pay the income tax. For some assets, such as an asset subject to a liability in excess of its basis, it may be advisable for the donor to continue to hold the asset so that the basis step-up at death (assuming there is an estate tax in effect) will wipe out the inherent income tax liability.

There has been some discussion among estate planners about whether gifts made in 2011 or 2012 that exceed $1 million (in other words, taking advantage of the temporary increase in the gift exemption) might be "clawed back" in the future, if the exemption amount reverts to $1 million. The law as currently written would not result in a clawback, and we think that specific legislation to cause a clawback is unlikely. Even if there were a clawback, however, for a variety of reasons it is likely that the donor (and her heirs) still would be better off than if the gift had not been made.

Techniques to Take Advantage of the 2-Year Window

It has always been true that estate tax savings are best achieved by lifetime gifting transactions. The temporary $5 million gift exemption and current market conditions of depressed asset values and low interest rates combine to provide an extremely favorable environment for gifts in 2011 and 2012. Consider the following transactions.

Choosing the Appropriate Asset for a Gift

The best asset to use in making a gift is one that the donor believes will appreciate rapidly in value. Sometimes the goal of gifting an appreciating asset is given an assist from a favorable valuation of the gifted asset. The value placed on an asset for gift tax purposes generally is the amount a willing buyer would pay a willing seller for the asset, neither being under any compulsion to buy or sell. This sensible and straightforward valuation rule enables a donor to take advantage of minority interest discounts, marketability discounts and other structuring techniques, so that the gift-tax value of the gifted asset often is less than its proportionate share of underlying asset value. At various times during the period leading up to the 2010 Act, legislation was proposed that would have limited the use of valuation discounts. Under one proposal, discounts would have been entirely eliminated for most entity interests where the underlying assets consist of securities and/or real estate. Changes to the discount rules were not included in the 2010 Act, but there is no guarantee that they will not resurface in the future. Capturing the benefit of discounted valuation is yet another reason to take advantage of lifetime gifting in 2011 and 2012.

Many of our clients have established a family investment entity (usually a limited liability company, or "LLC") as a vehicle to pool family assets (broadening the availability of different types of investment opportunities), to provide for succession management, to provide a vehicle for the younger generation to learn about investment and operation of the underlying business, and to achieve numerous other goals. An interest in such an LLC, which likely has features giving rise to discounted valuation, may be the ideal vehicle for a gift.

Gift to a Defective Grantor Trust

A gift may be made to a donee outright or to a trust for the donee's benefit. One efficient technique involves creating a trust to which the donor transfers property in a manner that constitutes a completed gift for gift tax purposes (taking advantage of the $5 million gift exemption), but which is structured as a "grantor trust" for income tax purposes. Grantor trust status means that the assets of the trust continue to be treated (for income tax purposes) as being owned by the donor. This, in turn, means that the earnings on the assets are taxable to the donor, even though the donor receives nothing from the trust. The donor's payment of income tax on the income of the trust is not taken into account as a gift for gift tax purposes. The assets of the trust grow free of income tax and the donor's estate is further depleted by the payment of income tax (funded by other assets of the donor) on the trust's earnings.

Leveraging a Gift: Part Gift / Part Sale to a Grantor Trust

The grantor trust gift described above may be leveraged by the donor's sale of assets to the trust in exchange for the trust's promissory note. The trust must have some equity, which the donor can provide by making a gift to the trust.

For example, suppose the senior generation member ("Senior") owns a 50% interest in Family LLC, which was previously established by Senior and members of her family. Family LLC's assets have a net fair market value of $20,000,000. Senior creates a trust for the benefit of her descendants ("Trust"), which is structured as a grantor trust for income tax purposes, as described above. Senior transfers a 49% interest in Family LLC to Trust. Because the 49% interest is a noncontrolling, nonmarketable interest, its value for gift tax purposes is determined by appraisal to be $6,800,000, reflecting a valuation discount of approximately 30%. Senior gifts a 28% interest to Trust, using approximately $4,000,000 of her lifetime gift exemption, and sells a 21% interest to Trust for a 9-year note with a principal amount of $2,900,000. The note bears interest at 2.44%, which is the IRS safe-harbor rate for a 9-year note issued in March, 2011. If the underlying assets are throwing off 4% per year (and the Family LLC distributes this amount to its members), Trust is receiving approximately $390,000 per year from its 49% interest in Family LLC and has more than enough cash flow to pay the annual interest and repay the principal over the term of the note.

If Senior's husband consents to gift-splitting, Senior could increase the amount gifted, using her own and her husband's gift exemptions to shelter the gift. With $10 million of total exemption amount, a married couple can transfer a very significant amount of wealth to the next generation during 2011 and 2012, without incurring any gift tax.

Dynasty Trusts

The increase in the GST exemption provides an opportunity to create a "dynasty" trust that continues for generations into the future (if a perpetual trust is desired, it would need to be established in a jurisdiction (such as Delaware) that has eliminated the "rule against perpetuities"). The grantor trust described in the examples above could be a dynasty trust for the benefit of Senior's grandchildren and more remote descendants.

If you would like to more information on the 2010 Act or any of the transactions discussed herein, please contact any member of our Estate Tax Planning Practice Team.

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