

# **THE O'NEILL COMPANY**

## **I N C O R P O R A T E D**

*Engineering the Development of Financial & Economic Literacy...*

*"Creating Financial Partnerships...Through the Fusion of Knowledge, Products, and Service."™*

### **ESTATE AND GIFT TAX CHANGES UNDER 2010 TAX ACT**

As you are undoubtedly aware, our new estate tax law is here. Congress has bestowed upon us significant benefits, continued uncertainty and a need to review most estate plans. Fortunately, existing estate planning opportunities for family wealth transfers remain intact and are now easier than ever to implement. Set forth below is a brief summary of the most relevant changes in the estate and gift tax laws for 2011 and 2012, as well as recommended action items.

#### **Estate laws for 2011 and 2012**

The following rules apply for gifts made and persons dying in calendar years 2011 and 2012:

- \$5 million per person estate tax exemption amount (\$10 million for married couples) with cost of living increases
- 35% maximum tax rate on estates in excess of the exemption amount
- \$5 million gift tax exemption with cost of living increases
- 35% maximum tax rate on gifts in excess of the exemption amount
- \$5 million generation-skipping transfer tax exemption with cost of living increases
- A full step-up (or step-down) in the income tax basis for inherited assets
- A carryover of unused exemption amounts from a deceased spouse to a surviving spouse (referred to as "portability")

#### **Estate Laws for 2013 et seq.**

In 2013 and thereafter, if Congress fails to act, the estate, gift and generation-skipping transfer tax exemptions revert back to the meager 2001 levels of \$1 million increased by cost of living; and the maximum tax rate reverts back to the confiscatory rate of 55%.

In view of the continued political tension between those who consider the estate tax an appropriate way for the government to raise much needed funds and those who consider the estate tax an unfair success tax, it appears that the only certainty will be continuing uncertainty. Prognosticators appear to be forecasting the following order of probability: (i) the \$5 million exemption amount with cost of living increases will be made permanent, (ii) the estate tax will be repealed, (iii) the estate tax exemptions will be reduced, or (iv) there will be continued uncertainty from legislative session to legislative session.

Of course, it is impossible to predict what Congress will do with any degree of certainty — especially after the woeful delay in fixing the 2010 tax issues.

## Chart of Estate and Gift Tax Laws

We have attached a chart regarding the changes in the estate and gift laws from 2009 through 2013.

### Portability

Perhaps the most interesting aspect of the new law is the newly created ability for a surviving spouse to utilize the unused estate tax exemption from a pre-deceased spouse without the necessity of creating a trust upon the death of the first spouse (called "portability").

For example, if the first spouse to die ("the decedent") leaves an estate of \$5 million outright to the surviving spouse ("the survivor"), none of the decedent's exemption amount would be used at the time of the decedent's death (since the entire estate went to the surviving spouse) and the unused exemption amount could be transferred to the survivor. The exemption amount available upon the death of the survivor would be \$10 million (the survivor's own \$5 million plus the decedent's unused \$5 million).

Formerly, under the above circumstances, it was necessary to utilize trust planning to preserve the decedent's exemption. The decedent's \$5 million estate was allocated into a separate trust for the benefit of the survivor; and the survivor was generally designated as the sole trustee of the trust for his or her benefit.

Although a distribution directly to the surviving spouse (using portability) would simplify the estate plan and would ensure a step-up in the income tax basis of property inherited from the survivor, having an estate plan that continues to provide for a trust to be created on the first death is still beneficial for a variety of reasons. Tax planning is only one reason for having a living trust provide for the creation of a second trust upon the death of the first spouse — the non-tax reasons for using such a trust are even more compelling than the tax reasons. Without trust planning (i) the survivor could leave the decedent's portion of the estate to anyone, e. g. a new spouse, a new spouse's family, caregivers, charity, etc., (ii) future creditors of the survivor could easily reach the assets of the survivor, (iii) any future appreciation in value from the decedent's death on the decedent's assets left outright to the survivor would be included in the survivor's taxable estate, (iv) the estate will not be able to utilize the decedent's generation-skipping exemption, consequently grandchildren or other beneficiaries may have a greater estate tax upon the later death of the decedent's child, (v) the unused exemption amount could be lost if the survivor remarries and the new spouse has already used his or her exemption through lifetime gifts, (vi) the portability only applies for persons dying in calendar years 2011 and 2012 unless Congress extends the law, i.e. the decedent's exemption may be forfeited if Congress does not make portability permanent.

### Estate Planning Techniques Not Curtailed

Congress considered, but fortunately failed to pass, two major tax reform proposals:

the elimination of valuation discounts on transfers among family members — a change that would severely limit the use of family limited partnerships, limited liability companies and gifts and sales of partial interests in real estate; and

2. restrictions upon the use of grantor retained annuity trusts (GRATS).

The use of valuation discounts in inter-family gift or sales planning and the use of grantor retained annuity trusts present tremendous opportunities to transfer wealth from one generation to another. This is particularly true in the current environment of substantially increased gift tax exemption amounts, depressed values and low interest rates.

The window of opportunity for such wealth transfer opportunities is now open but may be closing soon. There is no significant constituency for the preservation of either the continued use of discount planning or the use of GRATs. It could well be that Congress will enact the above reforms as part of future revenue raising legislation.

Planning - What to do now?

1. Consider amending current trust documents

The combination of the reinstatement of the full step-up in basis together with the substantial increase in the estate tax exemption amount may make it desirable to have all assets (i.e. both the decedent's share and the survivor's share) owned by the survivor rather than having the decedent's share of the assets held in a separate decedent's trust for the benefit of the survivor (which is common for most estate plans). Consequently, consideration should be given to:

- a. Restating the living trust so that a decedent's trust is not created upon the death of the first spouse. This is especially appropriate for:
  - small estates if there is no desire to utilize the protection of trusts; or
  - estates with large retirement plan accumulations which constitute the major portion of the estate.
- b. Amending current living trusts to provide flexibility that allows for a transfer of property from a decedent's trust to the survivor to achieve a step-up in income tax basis upon the death of the survivor if it is later determined that the decedent's trust is not needed for estate tax purposes. However, any such amendment must be weighed against the loss of protection offered by the use of the decedent's trust.

2. Consider gift planning

For estates which are likely to exceed the current exemption amounts or any future reduced exemption amounts after 2012, consideration should be given to implement a gifting program:

- to take advantage of the two year window allowing a \$5 million gift tax exemption
- to take advantage of the current low interest rates and depressed values
- to take advantage of evaluation discount planning

- to take advantage of the benefits of sales to grantor trusts and grantor retained annuity trusts which allow the grantor to continue to receive income and cash flow after the gift is made

3. Consider charitable lead trusts

Charitable lead trusts are generally appropriate for those who wish to make significant charitable contributions — especially beneficial in this low rate environment.

4. Review existing insurance program

Of course the uncertainty of the two year sunset provisions makes the decision of the appropriate amount of insurance difficult.

5. Review your existing estate plan

As always this is a good time to review your estate plan to ensure that, in addition to the tax planning, the terms are appropriate to meet your family needs and desires.

6. Ensure living trust is properly funded

Take time to ensure that all assets are properly titled in the name of the family trust and that beneficiary designations for retirement plans are properly prepared and submitted to the plan administrator or IRA provider.

## **The Economics of Wealth Transfer**

|                                  | 2009        | 2010  | 2011        | 2012                            | 2013, et seq.                              |
|----------------------------------|-------------|---|-------------|---------------------------------|--|
| <b>Estate tax exempt</b>         | \$3,500,000 | \$5,000,000(option for zero estate tax)           | \$5,000,000 | \$5,000,000 plus cost of living | \$1,000,000                                |
| <b>Maxium estate tax rate</b>    | 45%         | 35%   | 35%         | 35%                             | 55%  |
| <b>Gift tax exemption</b>        | \$1,000,000 | \$1,000,000                                       | \$5,000,000 | \$5,000,000 plus cost of living | \$1,000,000                                |
| <b>Gift tax rates</b>            | 45%         | 35%   | 35%         | 35%                             | 55%  |
| <b>GSTT exemption</b>            | \$3,500,000 | unlimited   | \$5,000,000 | \$5,000,000 plus cost of living | \$1,000,000 plus cost of living adjustment |
| <b>Step up(or down) in basis</b> | yes         | yes (option for limited step up if no estate tax) | yes         | yes                             | yes  |
| <b>Portability</b>               | no          | no  | yes         | yes                             | no   |