

DEATH TAX NOT DEAD

November 2010

Expiring Tax Laws Provide Estate Planning Opportunities - 2010 and Beyond

HARRY S.
MILLER

*is a Partner in the Firm's Tax and
Trusts & Estates Groups.*



JOSEPH R.
MARION III

*is an Associate in the Firm's
Trusts & Estates Group.*



The estate tax laws are currently in a state of uncertainty, which presents challenges for estate planning but also may present significant opportunities. Under tax laws adopted ten years ago, the estate tax exemption amount increased substantially over the past decade up to \$3.5 million last year, until the estate tax was entirely eliminated for this year. But under a quirk in the tax law, the estate tax will automatically come back into full force with a vengeance as of January 1, 2011, as it existed ten years ago with just a one million dollar exemption amount. It is expected that Congress will act to modify the estate tax law before year end, but in the meantime, there may be a window of opportunity for year end planning.

Estate Tax Changes

For the past year, most observers believed that Congress would act to prevent the one year repeal of the estate tax, and would freeze the exemption amounts at the 2009 \$3.5 million level. When Congress failed to act before year end 2009, it was assumed that legislation would be adopted this year which would be retroactive for 2010. So far, Congress has yet to take this step.

The retroactive re-enactment of the estate tax would certainly result in litigation regarding the constitutionality of such legislation, from estates of wealthy individuals who died during 2010. For

example, the estate of George Steinbrenner has been estimated by Forbes Magazine to be \$1.1 billion, which, depending on how it was structured, would have resulted in estate taxes of nearly \$500 million. But by dying in 2010 his estate could escape paying any estate taxes, if Congress fails to act to impose the estate tax retroactively. If Congress does enact such a law retroactively, the litigation challenging its constitutionality would likely extend over the next few years before the matter is finally resolved.

In the meantime, under the current law, if Congress does nothing, the estate tax will automatically be revived as of January 1, 2011 and going forward, at the pre-2001 rates and exemption amounts. Consequently, in the absence of Congressional action, next year the estate tax rates would be as high as 55%, with an exemption amount of just \$1 million. Congressional leaders have been working on compromise legislation over recent months which would prevent the estate tax from reverting to the pre-2001 levels, and would re-enact the estate tax at the 2009 level with a \$3.5 million exemption amount and a maximum rate of 45%.

The gift tax system is also in a state of uncertainty at present, based upon the same tax law enacted in 2001 which will expire at the end of this year. The gift tax law for the current year is reduced to 35%. Like the estate tax, the gift tax is also set to automatically revert to the pre-2001 levels as of the end of this year, which would mean a 55% tax rate. However, there is the same concern that Congress could enact new legislation retroactively, which would result in the gift tax rate being set at the maximum rate of 45% as it was last year.

Finally, there are also significant changes in the rules regarding the tax basis heirs take in inherited property. These rules also face an

uncertain future depending on Congressional action or inaction.

What to Expect and What to Do

Although most commentators expected a new gift and estate tax law to be adopted by Congress earlier in the year retroactively for this year, as the months have gone by there are greater questions as to Congress adopting retroactive legislation. Results of the mid-term elections now throw into further doubt the question of Congress reaching a compromise which would be adopted retroactively for 2010. This means that there is a possibility of 2010 remaining as a year without estate tax and with a historically low gift tax. Under these circumstances, estate planning is certainly challenging, but there may be special opportunities for planning which could be available at this time.

Aside from watching for Congressional action between now and year end, clients should consult with their attorneys regarding planning opportunities which may be appropriate for them, and perhaps more importantly, review their existing estate plan documents to consider the impact of the current and future tax law changes on their own situation.

Current Estate Planning Opportunities

Given the uncertainties of the federal estate tax law for 2010 and beyond, what are the planning choices that married couples and individuals should now consider?

Update Your Estate Plan!

Wills and trusts of married couples frequently define the bequests passing to or for the benefit of the surviving spouse by a formula that is described in terms of the federal estate tax exemption (or unified credit) available in the year of death. Typically the documents call for an amount equal to the federal exemption to pass into a "credit shelter" trust, with any amount in excess of the exemption to pass either

outright to the surviving spouse or into a separate marital trust. However, if the first spouse dies at a time when there is no estate tax and thus no exemption, how will such bequests be construed? To avoid such uncertainty, these couples' wills should be updated now to clearly define the bequest to the surviving spouse in the event that there is no estate tax applicable at the first spouse's death, or in the event that the exemption amount is very different than what was anticipated when the will was originally drafted.

Looking towards 2011 and beyond, when the exemption amount may be as low as \$1 million (if there is no Congressional action) or as high as \$3.5 million, \$5 million, or more, flexibility is the key principle of good drafting. One such flexible solution is to have an initial "all to my spouse" bequest in each spouse's will, but then provide for a contingent "credit shelter" trust that the surviving spouse can fund by making a post-mortem disclaimer of all or a specific percentage or amount of the bequest. With a disclaimer approach, the surviving spouse can choose exactly how much (if any) of the first spouse's estate to place into the credit shelter trust when the tax law is clear, in order to utilize some part or all of the first spouse's estate tax exemption. The surviving spouse could be the lifetime beneficiary of this trust, or it could be for their children, or both.

Lifetime Gifting

It is cheaper to pay gift tax now than it is to pay estate tax upon death, so making gifts during life is generally good planning. The low gift tax rates for this year, however, make it particularly attractive. In 2010, the gift tax rate has been reduced to 35%, compared to 2009's 45% rate and 2011's 55% rate. For the individual who has already used his or her \$1 million lifetime gift exemption, and can afford to make further gifts, now is an excellent time to gift cash or assets to a trust for children, or even better, for the benefit of grandchildren and more remote descendants. The downside to this technique is that gift tax has to be paid now instead of paying tax upon death. Analogous to Roth IRA conversions, there are significant benefits in most cases to paying the gift tax now. If you were planning on making taxable gifts anyway, doing so in 2010 before year end, may be extremely beneficial as it

may result in reducing the gift tax by 20%-30%.

For existing trusts that are not exempt from the generation-skipping transfer tax, referenced earlier, this year presents the perfect opportunity to make distributions to grandchildren, or more remote descendants of the creator of a trust, free from the generation-skipping transfer tax. With assets at depressed values and low interest rates, 2010 is also an excellent time for making loans and taking advantage of other gifting opportunities.

Family Limited Partnerships and LLCs

Even if there is permanent estate tax repeal, there will be good reasons, particularly with an active family business or family investments that are closely managed, to shift existing assets and future appreciation to younger family members while allowing the senior family members to retain control, especially during a period of depressed business values.

If the gift and estate tax laws get re-enacted, and there is going to be a change in these tax laws, one area that has been targeted for reform is the use of discounts in valuation. Since such discounts are one of the prime tax benefits of family limited partnerships, this provides another reason for planning now to take advantage of this tax saving opportunity while it still is available.

Charitable Planning

The charitable remainder trust (CRT), primarily an income tax planning vehicle, permits you to transfer appreciated property to a tax-exempt trust, which in turn sells the property and reinvests the proceeds and pays you an annuity or unitrust amount each year thereafter. This strategy also provides an estate tax deduction for the remainder interest passing to the charity when the trust ends. The CRT continues to be a valuable estate planning tool, especially in the current state of uncertainty. A charitable private foundation is another vehicle that serves important income and gift tax purposes, so its use should remain attractive in 2011.

Continued Role of Life Insurance

Many clients still need life insurance for purposes other than paying federal estate taxes. For example, life insurance will still be needed to fund business buy-sell

agreements, to serve as an income replacement for dependents of a deceased family breadwinner, and as a means of leveraging annual exclusion gifts. These needs will not be reduced by estate tax repeal and may increase with the proposed 2011 lower estate tax exemption. With the long delay and ultimate uncertainty of estate tax repeal, be careful about dropping or reducing existing life insurance coverage. An irrevocable life insurance trust (ILIT) remains an important planning technique to exclude life insurance proceeds from the gross estate.

Fund Grantor Retained Annuity Trusts

A Grantor Retained Annuity Trust ("GRAT") allows people to give a portion of an asset's future growth to heirs tax free. This type of trust works best when interest rates are low and asset values are depressed, and given the current economic environment, now is a perfect time to set up and fund a GRAT. Congress has targeted GRATs as another area for tax reform, which makes it even more important to proceed with such plans now, before year end.

One of the most tax advantaged planning opportunities for GRATs involves a short-term GRAT, for example, with a term of 2 years, funded by assets expected to substantially increase in value. If structured properly, the GRAT can be established in a manner so as to generate virtually no gift tax consequences, while passing substantial growth and appreciation in the assets to the next generation tax-free.

Congress has proposed a new restriction on GRATs which would require a minimum term of ten years. However, a ten year GRAT is much less attractive to many clients for a number of reasons. For people with shorter life expectancies, a ten year GRAT may not result in any tax savings, because the entire value of the trust will be subject to the estate tax if the donor dies before the end of the ten year term. Also, longer term GRATs are less desirable for clients who want to lock in short term gains on volatile assets.

The applicable federal rate set by the IRS is currently a record low of 2%, which means that all growth and profit on the GRAT assets in excess of 2% per year can be shifted to the next generation tax-free. By using

currently depressed asset values with the currently favorable rate set by the IRS, substantial wealth can be shifted efficiently to the next generation. However, if Congress acts, as expected, to require a minimum ten year term for GRATs, this method will not produce as much in tax benefits as available under the current rules. This is especially true in light of the current 35% gift tax rate. But even if Congress acts to establish the estate tax retroactively for 2010, it is considered unlikely that any reform of the tax law regarding GRATs would be adopted retroactively. Therefore, the window of opportunity for short term GRATs is likely to be available for GRATs established and funded before year end, regardless of Congressional action to re-enact the estate tax retroactively.

Non-Tax Reasons for Estate Planning

Even if the federal estate tax exemption amount is permanently increased to an amount that is well above the size of a couple's assets, there are still many non-tax reasons why you should have your estate plan periodically reviewed and updated. At a minimum, you need to have documents in place that adequately answer the following questions:

What will happen if during my lifetime I become unable to take care of my own personal and health needs?

What will happen if during my lifetime I am no longer able to manage my assets?

Who will receive my property at my death?

Who will settle my affairs after my death?

As to your intended beneficiaries, Congress obviously cannot legislate away problem areas such as spendthrift heirs, handicapped children, substance abuse, divorce, and immaturity. Protecting beneficiaries in these situations will remain an important estate planning goal.

Carryover Basis for Deaths in 2010

For those estates where death occurs at a time when the federal estate tax is not in effect (as of now, during calendar year 2010), inherited assets passing to beneficiaries, while escaping the federal estate tax, will be subject to the carryover basis rules. Simply put, Congress has replaced the loss of estate tax revenue in 2010 with income tax revenue.

Under the prior tax, law heirs took a basis in inherited assets equal to the fair market value of such assets as of the decedent's date of death (a "step up" basis). However, under the law in effect for this year, heirs would not have a step up basis, but rather would take a carryover basis equal to the decedent's basis in the property. Thereafter, under current 2010 law, the executor of an estate has the ability to allocate a credit of 1.3 million dollars of capital gains basis to any selected carry-over basis assets passing to the decedent's beneficiaries, and an additional \$3 million basis increase for carry-over basis assets passing to spouses. It is expected that Congress will also act to change this, but in the meantime these basis rules must be considered in estate planning and tax planning for sales of inherited property.

Caveat on MA and RI Estate Tax

The changes in federal estate law will not

affect the Massachusetts and Rhode Island Estate Tax, which will continue to be imposed on the transfer of taxable property at death (other than to the surviving spouse). The first \$1 million of estate property is exempt from taxation in the Commonwealth. The corresponding exemption in Rhode Island is lower, at \$850,000.

For questions regarding this Tax & Estate Planning Advisory, please contact your Burns & Levinson estate planner or either of the following attorneys:

Harry S. Miller
617.345.3236 / hmiller@burnslev.com

Joseph R. Marion III
401.831.8370 / jmarion@burnslev.com

To learn more about our Trusts & Estates practice, please visit: <http://www.burnslev.com/our-practices/trusts-estates>. For further information on our Tax practice, please visit: <http://www.burnslev.com/our-practices/tax>.

Applicable Treasury Regulations require that you be informed that any U.S. tax advice contained in this communication and any attached documents is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding U.S. tax penalties.

About Burns & Levinson

Burns & Levinson is a full-service law firm with over 125 attorneys based in Boston with additional offices in Providence and New York. The firm has grown steadily and strategically throughout the years and has become a premier law firm with regional, national and international clientele. The firm has expertise in corporate law, finance, venture capital, private equity, tax, bankruptcy, lending and leasing, real estate, business litigation, government investigations and white collar crime defense, intellectual property - including patent law, and a large private client group - including estate planning, probate and trust litigation, divorce and other family law issues. In addition, the firm has a wholly-owned subsidiary office in Montreal, Quebec, to service its Canadian clients. For more information, visit Burns & Levinson at burnslev.com.