

New Federal Tax Law Includes Significant Estate, Gift and Generation-Skipping Transfer Tax Changes

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- The federal estate tax is reinstated for 2010 (albeit with an opt-out provision), 2011 and 2012;
- The GST tax is effectively eliminated for 2010 and reinstated for 2011 and 2012;
- The top estate tax and GST tax rate is capped at 35%;
- Each taxpayer receives an exemption from the estate and GST taxes of \$5,000,000;
- From 2011 on, the unified gift/estate exemption will allow larger lifetime gifts; and
- For married couples, a surviving spouse may potentially use some or all of the deceased spouse's unused unified gift/estate exemption.

Reinstatement of the Estate Tax and 2010 Opt-out: The Act retroactively reinstates the estate tax for 2010, 2011 and 2012 as if it had not expired on December 31, 2009, but with a new higher exemption and lower rate (see below). Executors of decedents who died in 2010 prior to enactment of the Act, however, may opt out of the new estate tax law. That is, executors of 2010 decedents may choose between (i) an estate tax with a 35% rate, a \$5 million exemption, and a step up of income tax basis to date of death values, or (ii) no estate tax and a limited step up of income tax basis at death. The ability to elect out of the estate tax for 2010 should quiet constitutional objections to this retroactive tax. Executors of 2010 estates over \$5 million will need to balance the probable future income tax cost of a lower basis under the limited step up rules against the estate tax that would be payable under the new tax regime. It appears that virtually no estate under \$5 million should opt out of the new regime.

The New Estate Tax Regime: Exemptions and Rates: Estates of decedents dying in 2011 and 2012 are only eligible for the new estate tax regime. Each individual will have an exemption from the tax (actually a credit against the tax computed to exempt value in the estate equivalent to the specified

exemption) of \$5,000,000. Tax will be imposed above that value at a rate of 35%. This exemption will be usable against gifts during life or against inheritances passed at death (see Reunification of the Gift and Estate Exemptions, below). The exemption is indexed for inflation in future years.

Partial Reinstatement of the GST Tax: While the GST tax is also reinstated, the retroactive reenactment of the GST tax should likewise avoid constitutional challenge, since the GST tax rate for 2010 is 0%. Recognition of generation-skipping transfers made in 2010 is, in fact, a boon to taxpayers, as it clarifies that the "holiday" from GST tax in 2010 will "stick" in later years. The GST tax rate increases to 35% in 2011 to match the estate tax rate. The exemption against the GST tax is likewise \$5,000,000 (also indexed for inflation) and can be applied to transfers made during the taxpayer's life. Note: There may be advantageous year-end planning opportunities for a limited number of clients under this rule. For instance, clients who have remaining gift tax exemption under the 2010 limit (\$1 million) and who wish to make large direct gifts to grandchildren or great-grandchildren presumably may do so without using GST exemption and without incurring tax. Immediate action must be taken to effect such transfers, however.

Reunification of the Gift and Estate Exemptions: The Tax Act does not leave the gift tax untouched. As many have long desired, the gift tax will be reunified with the federal estate tax. That is, the exemptions from gift tax and estate tax will again be the same; however, this part of the Tax Act does not take effect until January 1, 2011. In 2010, the exemption from gift tax is still \$1 million, while the exemptions from federal estate tax and GST tax have been increased to \$5 million. In 2011, the exemption from gift tax will join the others at \$5 million.

Portability of Spouse's Exemption: In a radical departure from prior estate tax law,

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Act") was signed into law on December 17, 2010. In the eleventh hour, after months of debate over extension of the Bush-era tax cuts, and with comparatively little attention given to the estate, gift, or generation-skipping transfer taxes, the President and Congress have radically altered the transfer tax landscape (at least for the next two years, when the Tax Act is also scheduled to expire).

Return of the Estate and GST Taxes: As provided under the tax cut enacted in 2001, the federal estate tax and the generation-skipping transfer ("GST") tax were repealed on December 31, 2009. Both these taxes, however, were also scheduled to come back at higher 2001 levels when the Bush-era tax cuts expired on December 31, 2010. As written, the law provided that the top estate tax rate and the GST rate would rise to 55%, and both taxes would have had an exemption of only \$1 million (adjusted for inflation). There was also uncertainty, under prior law, as to how generation-skipping transfers that occurred in 2010 should be accounted for when the GST tax returned in 2011.

The Tax Act eliminates the whiplash rate change from 0% to 55% as well as the GST tax quandaries, while making other significant changes in the law. The changes, which receive further explanation below, are as follows:

the Tax Act gives the executor of the first spouse to die (the "predeceasing spouse") the power to pass the predeceasing spouse's unused federal estate tax exemption on to the surviving spouse. This election would be made on the predeceasing spouse's timely filed estate tax return. For example, the executor of a predeceasing spouse with a taxable estate of \$2 million that passes to children or a family trust could provide for the surviving spouse's estate to utilize the predeceasing spouse's remaining \$3 million exemption. As another example, the executor of a predeceasing spouse who leaves everything to the surviving spouse could give the estate of the surviving spouse the predeceasing spouse's entire \$5 million exemption. The intent is to avoid the need for so-called "bypass" or "credit shelter" trusts solely to shelter this exemption. Those trusts, of course, are still useful to guide the direction of family wealth, shelter the post-death growth in the predeceasing spouse's estate from estate tax at the death of the surviving spouse, and provide creditor protection and other trust benefits. In addition, bypass or credit shelter type trusts will still be necessary to preserve the predeceasing spouse's estate tax exemption in states like Massachusetts, which still have a state estate tax that does not provide such portability. The portability provisions of the Tax Act apply to decedents dying on or after January 1, 2011.

The estate, gift and GST tax provisions of the Tax Act will no doubt raise as many questions in the minds of attorneys and clients alike as they purport to answer. While in general the Tax Act avoids the need to make hasty decisions before year end, the long-range decisions it may engender are important and may be difficult to answer. Clients and friends of Burns & Levinson LLP with questions on the new law are encouraged to call us, or your principal attorney at the firm, at any time.

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