

Transfer Tax Update

March 2011

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act"). The Tax Relief Act makes significant – but temporary – changes to the federal estate, gift and generation-skipping transfer taxes. The lower tax rates and higher exemption amounts provided by the Tax Relief Act offer new opportunities for tax-favorable wealth transfer planning. However, the changes also have the potential to disrupt the operation of some existing estate plans.

SUMMARY OF RELEVANT PORTIONS OF THE TAX RELIEF ACT

Federal Estate Tax

Under the Tax Relief Act, the federal estate tax will be assessed at a flat rate of 35%, down from a rate of 45% in 2009 and 55% under 2001 law. The first \$5 million in assets will be exempted from tax (this \$5 million will be reduced by any taxable gifts made during life), an increase from \$3.5 million in 2009 and \$1 million under 2001 law. Additionally, the \$5 million estate tax exemption will be indexed for inflation in 2012. As under prior law, no estate tax is due on any amount left to a surviving spouse (or to certain trusts for the benefit of a surviving spouse) or to charities.

The Tax Relief Act also allows a surviving spouse to use the unused exemption of a deceased spouse. This "portability" provision is an entirely new concept in the estate tax. More specifically, if a spouse dies in 2011 or 2012, the surviving spouse may add the deceased spouse's unused estate tax exemption to his or her own exemption. For example, if a deceased spouse dies leaving a \$3 million estate, the surviving spouse could add the deceased spouse's unused \$2 million estate tax exemption to her own exemption, thus giving her a total exemption of \$7 million. The surviving spouse may use this exemption to shelter lifetime gifts from the gift tax or to shelter assets owned at death from the estate tax.

Portability is subject to important limitations. If a surviving spouse has more than one predeceased spouse, he or she may use only the unused exemption of the most recently deceased spouse. Moreover, a predeceased spouse's unused exemption does not increase for inflation. Finally, in order to allow the surviving spouse to claim the predeceased spouse's exemption, the predeceased spouse's executor must timely file a federal estate tax return and make the proper election.

Federal Gift Tax

The Tax Relief Act extends into 2011 and 2012 the top marginal gift tax rate of 35% that, prior to enactment, was applicable only in 2010. The Tax Relief Act also increases the federal gift tax exemption in 2011 and 2012 from \$1 million to \$5 million (adjusted for

inflation in 2012). The additional \$4 million gift tax exemption is available even to individuals who made prior gifts that exceeded the \$1 million exemption and thus paid a federal gift tax. As before, no gift tax is applicable to gifts to a spouse (or to certain trusts for a spouse) or to charities.

The decreased marginal rate and increased exemption serve to “reunify” the federal estate and gift tax rates and exemptions. This means that, beginning in 2011, any gift tax exemption used during life reduces the estate tax exemption available at death on a dollar-for-dollar basis.

Federal Generation Skipping Transfer Tax

The Tax Relief Act also makes revisions to the federal generation-skipping transfer tax, which is the tax that applies to transfers to those who are two or more generations younger than the transferor, such as grandchildren. Under the Tax Relief Act, the federal generation-skipping transfer tax exemption for 2011 and 2012 is \$5 million (adjusted for inflation in 2012); the tax rate applicable to generation-skipping transfers is 35%. Importantly, the generation-skipping transfer tax exemption is not portable between spouses.

SOME OBSERVATIONS ABOUT THE IMPACT OF THE TAX RELIEF ACT ON ESTATE PLANNING

Tax Relief Act Provides Significant Opportunities for Wealth Transfer

Under the Tax Relief Act, with proper planning, a married couple can pass up to \$10 million of property to their children and other beneficiaries without incurring any federal estate or gift taxes. These increased exemptions from the federal estate and gift taxes can be combined with the increased generation-skipping transfer tax exemption to create a substantial legacy of up to \$10 million to children, grandchildren and more remote descendants without the imposition of *future* federal estate, gift and generation-skipping transfer taxes.

Tax Relief Act is Temporary

The provisions of the Tax Relief Act are applicable only for a short time. Unless Congress passes further legislation, all of these new provisions will expire at the end of 2012 – and with unsavory results. If Congress allows the Tax Relief Act to expire, there will be a \$1 million exemption for federal estate and gift taxes; the exemption from the federal generation-skipping transfer tax will be \$1 million adjusted for inflation. The top marginal rate for federal estate and gift taxes will be 55% (plus an additional 5% surcharge applicable to large estates and gifts), and the generation-skipping transfer tax will be assessed at a flat 55% rate.

Potential Impact on Formula Provisions in Estate Planning Documents

Although the changes occasioned by the Tax Relief Act are beneficial, they may have unintended effects on many existing estate plans. More specifically, many wills and revocable trusts divide property at death pursuant to formulas that are intended to maximally use available estate and generation-skipping transfer tax exemptions and minimize or defer the imposition of federal and state estate taxes. Estate planners use these

formulas so that clients will not need to change their estate planning documents each time Congress makes changes to the transfer tax laws. However, when Congress makes substantial – and somewhat unanticipated – changes to these laws, these formula provisions may create unintended consequences.

Consider, for example, the current plan of many married couples, which is designed to avoid all federal estate tax at the first spouse's death and to minimize the overall federal estate tax. Under the plan, the assets of the first spouse to die are divided into two portions: a "Family Share", consisting of property equal in value to the federal estate tax exclusion, and a "Marital Share", consisting of the balance of the deceased spouse's property. Generally, the Family Share benefits the surviving spouse and the couple's children; however, in some instances, it benefits the spouse only or the children only. The Marital Share may pass to the surviving spouse outright or to a trust for the surviving spouse's lifetime benefit.

Now assume that the deceased spouse had an estate of \$6 million. In 2009, the formula described above would have allocated \$3.5 million to the Family Share and \$2.5 million to the Marital Share. Under the terms of the Tax Relief Act, that same formula would allocate \$5 million to the Family Share and only \$1 million to the Marital Share. By automatically allocating a greater portion of the deceased spouse's assets to the Family Share, the formula might have the effect of reducing the surviving spouse's access to funds, or, in the extreme case, of disinheriting the surviving spouse altogether. These results likely are inconsistent with the client's original intent.

While the effects of formula provisions discussed above may be more pronounced in the estates of married couples, any estate plan that divides property based on the federal estate tax or generation-skipping transfer tax exemptions may be impacted by the provisions of the Tax Relief Act.

Portability is no Panacea

As discussed above, under prior law, estate planning for married couples ordinarily involved preparing estate planning documents that contained formula provisions that divided the estate of the first spouse to die into a Family Share and a Marital Share. A couple also would divide their assets during life such that, regardless of which of them died first, the deceased spouse would have sufficient assets to fully fund his or her Family Share. The estate plan was structured in this way because, prior to enactment of the Tax Relief Act, any unused estate tax exemption of the first spouse was not available to the surviving spouse.

The Tax Relief Act introduced the concept of portability, pursuant to which a surviving spouse may add to his or her federal estate and gift tax exemption the unused portion of the deceased spouse's exemption. This portability may indeed enable married couples to have simpler estate plans than before. However, it absolutely does not eliminate the need for estate planning or the efficacy of trusts in that planning. More specifically, in addition to transfer tax savings, trusts also can be used to shelter future appreciation of assets from tax in the surviving spouse's estate. Trusts also are extremely useful vehicles for asset management, creditor protection, and planning for grandchildren and more remote descendants and beneficiaries with special needs. Finally, it is important to remember that the portability provisions of the Tax Relief Act are temporary, and, as such, it is possible that

portability will not be available for spouses dying after expiration of the Tax Relief Act on December 31, 2012.

CONCLUSION

The Tax Relief Act introduces significant new opportunities to shift wealth to family members and other beneficiaries with reduced or no estate, gift and generation-skipping transfer taxes. However, application of many of the provisions of the Tax Relief Act can disrupt the operation of many existing estate plans, produce unintended consequences, interfere with the intended distribution of assets, and trigger the imposition of taxes that otherwise might be avoidable. Accordingly, now is the ideal time to review the provisions of your estate plan, to ascertain the impact of the Tax Relief Act on your plan, and to implement any changes that may be appropriate in light of the provisions of the Tax Relief Act or other changes in circumstances or in your wishes since you last reviewed your plan.

If you want to discuss the Tax Relief Act or any other matter relating to your estate plan, please do not hesitate to contact us as follows:

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