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New Estate and Gift Tax Laws for 2011- 2012 and Transfer Tax Provisions of the President's Proposed Budget for 2012

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On December 17, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which included new estate and gift tax laws applicable in 2011 and 2012. These laws provide opportunities to transfer assets to your desired beneficiaries at a tax cost that is significantly lower than under the tax laws prior to 2010. On February 14, President Obama released his proposed budget for the U. S. government in fiscal year 2012. Here is a brief summary of the new federal estate and gift tax laws in effect for 2011 and 2012, plus a look at how the President's proposed budget would affect federal estate and gift taxes, if enacted.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

The Estate Tax

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act") establishes a $5 million estate tax exemption (the "applicable exclusion amount") and a 35% maximum federal estate tax rate, applicable from the beginning of 2010 through the end of 2012. Those who inherit property under this regime may apply a step-up in basis for income tax purposes.

However, the estates of decedents who died during 2010 have the option to elect out of the estate tax laws under the Tax Relief Act. In so choosing, the estate would be subject to no federal estate tax, but all inherited property would be subject to modified carryover basis for income tax purposes. Please see the section on "Administration of Estates of 2010 Decedents," below, for a more detailed discussion.

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The Gift Tax

The estate and gift tax exemption amounts are unified, resulting in a $5 million dollar gift tax exemption applicable to gifts made in 2011 and 2012. The gift tax rate during this time is 35%. Allocation of available gift tax exemption during one's lifetime will reduce the estate tax exemption amount available upon death.

Even if a person has already made taxable gifts and allocated the full $1 million of the prior maximum gift tax exemption amount, such person will now have a "new" gift tax exemption of $4 million in 2011 due to the increase in the gift tax exemption to $5 million under the Tax Relief Act.

If Congress does not enact another gift tax law before the end of 2012, the gift tax rate will increase to 55% beginning in 2013, and the gift tax exemption will return to $1 million. Therefore, 2011 and 2012 are opportune years to make gifts of cash or other assets, either outright or in trust, if financial circumstances permit and one is so inclined.

The Generation-Skipping Transfer (GST) Tax

The GST tax exemption and tax rate in 2011 and 2012 are equal to the applicable exclusion amount and maximum estate tax rate: a $5 million GST exemption; and a 35% GST tax rate.

There is a GST exemption amount of $5 million applicable to generation-skipping transfers made in 2010. However, the GST tax rate applicable to generation-skipping transfers (for example, gifts to grandchildren and descendants of lower generations, taxable terminations and taxable distributions from trusts) made in 2010 is 0%.

Allocation of GST exemption is automatic in some cases unless the donor timely elects out of this automatic allocation. The time for electing out of this automatic allocation is extended to September 19, 2011 for generation-skipping transfers in 2010, but the deadline for elections with respect to other transfers is the gift tax return due date. It would not be appropriate to allocate exemption to most transfers that are taxable at a 0% rate. We recommend contacting a professional advisor prior to the due date for 2010 gift tax returns.

It may be advisable to allocate additional GST exemption to a trust that currently has a greater than zero inclusion ratio, as there is an increased GST exemption applicable in 2011 and 2012. For example, a trust that has been allocated the maximum available (before 2011) GST exemption amount of $3.5 million could receive an additional $1.5 million of GST allocation in 2011 or 2012, to exempt additional assets from GST tax.

If Congress does not act, the GST exemption amount will return to $1 million (indexed for inflation, to approximately $1,360,000) with a GST tax rate of 55% for transfers made starting in 2013. Therefore, 2011 and 2012 provide an opportunity to make gifts to grandchildren and descendants of younger generations while the $5 million exemption is in place and a lower 35% rate is applicable.

GST exemption allocated to a trust could expire after 90 years under a proposal set forth in the Obama Administration's suggested Budget for 2012; please see below for a more detailed discussion of this proposal.

The Portability of the Unified Credit Between Spouses

The Tax Relief Act establishes portability of the applicable exclusion amount between spouses. The portion of the $5 million applicable exclusion amount not used by a deceased spouse's estate may be used by the surviving spouse. However, under the Tax Relief Act, in the case of multiple marriages portability is limited to only the most recently deceased spouse.

In order to take advantage of this rule, the executor of the deceased spouse's estate must affirmatively elect portability on a timely filed estate tax return.

There is no portability for GST tax exemption purposes. If portability "sunsets" at the end of 2012, as the Tax Relief Act provides, this benefit will be lost, therefore reliance upon portability for estate planning purposes is risky. However, please see the discussion of the Obama Administration's proposed budget, below, as portability could be made permanent in the future.

Administration of Estates of 2010 Decedents

The deadline for filing tax returns and making disclaimers for the estate of a decedent who passed away in 2010 (a "2010 decedent") is extended to September 19, 2011. The deadline for paying estate tax on the estates of 2010 decedents also is extended to September 19, 2011.

The executor of the estate of a 2010 decedent has the option to elect out of the estate tax laws under the Tax Relief Act. Section 301(c) of the Tax Relief Act provides that "[s]uch election shall be made at such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide." As of the writing of this Advisory, the IRS has announced that the election will be made on Form 8939, which will be not be due until at least 90 days after the form is released.

By electing out of the estate tax laws under the Tax Relief Act, an estate would be subject to no estate tax, but the basis of inherited property for income tax purposes would be the same as the decedent's basis, with limited adjustments.

A beneficiary of an estate of a 2010 decedent may want to disclaim his or her inheritance in favor of a skip person (i.e., a child of a 2010 decedent may want to disclaim an inheritance in favor of a grandchild of the decedent), in order to take advantage of the 0% GST tax rate for 2010 transfers.

The option to elect out of the estate tax may result in conflicts among the beneficiaries of an estate of a 2010 decedent. If you are administering the estate of a decedent who passed away in 2010, we suggest contacting a professional advisor to determine if this option would result in tax savings for that estate.

The Obama Administration's Proposed Tax Reforms for 2012

The Obama Administration's proposed "Budget of the United States Government, Fiscal Year 2012" (the "2012 Budget Proposal") was released on February 14, 2011. The Department of the Treasury thereafter released its "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals," aka the "Green Book," which discusses and explains the tax portions of the 2012 Budget Proposal.

The 2012 Budget Proposal is the executive branch's recommendation for the federal budget starting October 1, 2011, the beginning of the 2012 Fiscal Year. The 2012 Budget Proposal is not legislation pending before Congress.

Portability of Unified Credit Made Permanent

As discussed above, the Tax Relief Act provides that the portion of the $5 million applicable exclusion amount not used by a deceased spouse's estate may be used by the surviving spouse. Under the language of the Tax Relief Act, portability would expire at the end of 2012, when the exemption amount would return to $1 million per individual (barring Congressional action in the interim).

The 2012 Budget Proposal includes a provision that would make portability of unused applicable exclusion amount between spouses permanent after the expiration of portability under the Tax Relief Act. The use of a deceased spouse's remaining applicable exclusion amount would be permanently available to surviving spouses for decedents dying and gifts made after December 31, 2012.

Consistency in Valuation for Transfer Tax and Income Tax Purposes

Currently, federal tax law does not explicitly require that a donee's basis in property (for income tax purposes) be the same as the value that is reported for the donor's estate or gift tax purposes, as the case may be. The 2012 Budget Proposal requires consistency between income and transfer tax valuations of transferred property.

The 2012 Budget Proposal presents a consistency requirement for property received by lifetime gift or upon a donor's death. A donee's basis for property received upon a donor's death would equal the value of the property used for the donor's estate tax purposes. (If a 2010 decedent's executor elects out of the estate tax, as discussed above, the donee's basis in property would be the lesser of the decedent's basis in the property, with limited adjustments, or the fair market value of the property on the decedent's date of death.) A donee's basis for property received from a donor during the donor's life would equal the donor's basis in the property (increased to include the gift tax paid by the donor on post-1976 appreciation).

In addition, the 2012 Budget Proposal introduces a requirement that the donor or the executor of a decedent donor's estate provide property valuation information to the donee and to the IRS.

If enacted, these valuation rules would apply to transfers made after the date of enactment. The implementation and administration of these new consistency and reporting requirements would be explained by the Department of the Treasury in further detail if this portion of the 2012 Budget Proposal is enacted.

Modify Rules on Valuation Discounts for Family-Controlled Entities

Under its 2012 Budget Proposal, the Obama Administration aims to eliminate discounts attributable to restrictions on liquidation when valuing interests in family-controlled entities transferred to members of the transferor's family.

If this portion of the 2012 Budget Proposal is enacted, it would apply to property transferred after the date of enactment. However, restrictions on liquidation imposed by an agreement made prior to October 8, 1990 would be "grandfathered" (i.e., not disregarded). The proposal would eliminate discounts for partnerships and LLCs that own marketable securities.

We suggest that you speak with a professional advisor to discuss whether transferring interests in family-held entities in the short-term (before the suggested valuation laws are enacted) could result in tax savings and the protection of assets for your beneficiaries.

Limitations on Grantor-Retained Annuity Trusts (GRATs)

A grantor-retained annuity trust ("GRAT") is an irrevocable trust to which the grantor contributes property and retains the right to an annuity for a fixed term of years. The amount of the gift to the trust is the excess of the value of the property conveyed to the trust over the present value of the annuity. Typically, the gift amount is nominal. Any appreciation of the assets held in the trust over the annuity payments will pass to the beneficiaries free of gift tax. If the assets fail to appreciate, the remainder beneficiaries will not benefit from the GRAT but the grantor will not have incurred gift tax for enjoying the opportunity to benefit the remainder beneficiaries. If the grantor survives the term of the annuity, the appreciation of the assets is not included in the grantor's estate. If the grantor dies before the term expires, all or a portion of the appreciation of the assets in the GRAT will be included in the grantor's gross estate. To increase the probability of the grantor surviving the term and to increase the probability of successful performance, shorter-term GRATs have been popular estate-planning devices.

The 2012 Budget Proposal recommends that: (i) GRATs be required to have a minimum term of 10 years; (ii) GRATs must have remainder value of more than zero; and (iii) the grantor's annuity cannot decrease during the term of the GRAT. If enacted, these rules would apply to trusts created after the date of enactment.

If this portion of the 2012 Budget Proposal becomes law, these rules would make it more challenging for grantors and their beneficiaries to benefit from GRATs. This is of particular concern for older clients, because if a grantor does not survive the GRAT term, some or all of the GRAT will be included in the grantor's gross estate.

If you own assets for which values are currently depressed, a GRAT may be an effective vehicle to shift the anticipated appreciation to your beneficiaries. It is especially effective when the grantor contributes rapidly appreciating assets to a GRAT. We suggest that you contact a professional advisor to determine if establishing a GRAT would be a beneficial part of your estate plan.

Limit the Duration of GST Exemption to Ninety Years

The 2012 Budget Proposal suggests imposing a 90-year limit on GST tax exemption for trusts. In short, on the 90th anniversary of the creation of a trust, any GST exemption allocated to that trust would expire (the inclusion ratio of that portion of the trust would change from 0 to 1), and distributions from that portion of the trust to skip persons (and other generation-skipping transfers) thereafter would be subject to GST tax.

This 90-year restriction would apply to trusts created *after* the enactment of the rule, or to funds added to an already existing trust *after* the date of enactment.

Note, also, that for trusts created *after* the date of enactment, there is an opportunity for extension of the term. If, before the 90th anniversary of the creation of a trust (for this example, “Trust A”), Trust A’s GST-exempt property is transferred to a second trust for the benefit of a Trust A beneficiary (“Trust B”), and Trust B meets the requirements of Internal Revenue Code Section 2642(c)(2), the inclusion ratio on the Trust A property transferred to Trust B will remain at 0 (GST-exempt) and will not be changed to 1 (GST non-exempt). In this example, Trust B must meet both of the requirements of Section 2642(c)(2): (i) Trust B is for the benefit of an individual, and no income or corpus may be distributed to anyone else during that beneficiary’s life and (ii) if Trust B does not terminate before the beneficiary dies, Trust B will be included in the beneficiary’s estate.

Trusts created *before* the enactment of this rule would be “grandfathered” and this rule would not apply to such trusts; for example, this rule would not apply to a GST-exempt trust that is currently in existence. Therefore, there is a very strong incentive to set up GST-exempt trusts, particularly trusts created with the intention that they exist forever (so-called “Dynasty Trusts”), in the near future, in case this proposal is enacted.

We suggest that you contact a professional advisor at your earliest convenience to discuss whether establishing a Dynasty Trust before new laws are enacted would result in tax savings for your estate.

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