

## **Estate Tax Reform - A Window of Opportunity**

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*Gould & Ratner LLP Estate Planning and Tax Update*

Long-awaited legislation to resolve the uncertainty due to the temporary repeal of the federal estate and generation-skipping transfer ("GST") taxes for 2010, was signed into law on December 17, 2010. In addition to addressing the expiring estate, gift and GST tax provisions, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Act") includes a two-year extension of the 2001 income tax and capital gains tax rates, and a one-year reduction in the Social Security withholding tax on wages and self-employment income.

### **Unification of the Transfer Taxes**

In general, the 2010 Act reinstates the estate tax, but with an exemption from the estate, gift and GST taxes for transfers up to \$5 million per Individual transferor and sets the maximum transfer tax rate at 35%. The increased exemption also applies in 2010 for GST and estate tax purposes but the gift tax exemption remained \$1 million for 2010 gift transfers.

### **Estate Tax Provisions**

The estate tax exemption amount is \$5,000,000 per individual and \$10,000,000 per married couple for 2010, 2011 and 2012, and is indexed for inflation after 2011. The top tax rate for estates in excess of the exemption amount is 35% for the years 2010 through 2012.

### **Gift Tax Provisions**

As noted above, for gifts made in 2011 and 2012, the gift tax is reunified with the estate tax, meaning that an individual's \$5,000,000 exemption (\$10,000,000 for a married couple) may be used for gifts during life or for assets passing upon death. Thus, individuals who have already fully used the current \$1,000,000 lifetime gift tax exemption will now have another \$4,000,000 of exemption available. Lifetime gifts over \$5,000,000 will be subject to tax at 35%.

### **GST Tax Provisions**

There is also a \$5,000,000 GST exemption for 2010, 2011 and 2012. GST gifts above \$5,000,000 made in 2010 will not be subject to GST tax (but will be subject to gift tax if they exceed the \$1,000,000 gift tax exemption). GST gifts above \$5,000,000 in 2011 and 2012 will be subject to GST tax at 35%. As with the

estate tax, the time to file a GST return for 2010 transfers is extended to no earlier than nine months after the date of enactment of the 2010 Act.

### **Administration of Estates – Date of Death in 2010**

For decedents dying in 2010, the 2010 Act provides that the estate tax applies retroactively. As discussed above, there is a \$5 million estate tax exemption and a 35% top rate, and the tax basis of property acquired from a decedent is adjusted, generally, to its fair market value at the time of death. The estate tax return and payment of the estate tax is extended to no more than nine months from the date of enactment of the 2010 Act for estates of decedents dying in 2010.

However, the executors of estates of decedents who died in 2010 can elect out of the estate tax regime so that no estate tax is due. If such an election is made, a limited adjustment or a “step-up” in the basis of appreciated qualified inherited property is permitted. The time and manner for making such an election will be determined by the IRS. The generation-skipping tax provisions of the 2010 Act continue to apply to 2010 decedents regardless of the election to opt out of the estate tax.

For a significant number of estates of \$5 million or less (including gifts made during life in excess of annual exclusion gifts), an executor should not elect out of the application of the estate tax, because no tax is due and a full basis step-up will be permitted. If the value of the decedent’s estate exceeds \$5 million, the executor should consider whether or not the benefits of the additional basis step-up are outweighed by the estate tax that would otherwise be due.

### **Portability is Allowed Under the 2010 Act**

If a decedent dies in 2011 or 2012 leaving a surviving spouse, the surviving spouse can use that portion of the estate tax exemption that was not used by the first spouse to die, but an election must be made on the deceased spouse’s estate tax return, even if an estate tax return would not otherwise be required. For example, if a husband dies survived by his wife, and the husband’s estate utilized only \$3,000,000 of his \$5,000,000 exemption, the wife during her lifetime, or her estate upon her subsequent death, will have a combined federal gift and estate tax exemption of \$7,000,000 (\$2,000,000 of the husband’s unused exemption plus the wife’s \$5,000,000 exemption). The wife may use this \$7,000,000 exemption to pass assets either during her lifetime or upon her death free from transfer tax.

### **Limitations of Portability on Planning**

While portability may permit spouses to utilize \$10,000,000 of combined estate tax exemption (without regard to which spouse is the transferor) during lifetime or upon death, it is not without complications. For example, the GST tax exemption is not portable. In order for the estate of the first deceased spouse to use

his or her GST tax exemption, a traditional “credit shelter” trust should be part of the deceased spouse’s estate plan. A further benefit of a typical estate plan that utilizes a “credit shelter” trust is that it allows for the appreciation in the assets held in the “credit shelter” trust from the date of the first spouse's death and the date of the surviving spouse’s death to avoid estate tax. On the other hand, simply relying on the portability rule to utilize both spouse’s estate tax exemptions will not allow that increase between deaths to avoid estate tax where the spouses’ combined estates exceed the sum of the exemptions.

Finally, it is important to remember that unless Congress takes further action, the portability of exemptions is only available through December 31, 2012, and so should probably not be relied upon for long-term estate planning purposes.

### **Impact on State Estate Taxes**

Largely in response to the enactment of the new Federal estate tax law, Illinois reinstated its estate tax effective as of January 1, 2011, with an exemption amount equal to \$2,000,000. The practical effect of this is that some estates that are not subject to Federal estate tax because of the application of the \$5 million federal exemption, will remain subject to Illinois estate tax. On the other hand, Illinois does not currently impose a gift tax so Illinois residents may have added incentive to make gifts during lifetime to utilize their federal estate and gift exemptions and thereby reducing their exposure to the Illinois estate tax.

### **Notable Proposals Not Included in New Legislation**

The 2010 Act did not include prior proposals to require a 10-year minimum term for grantor retained annuity trusts (“GRATs”). Given the historically low interest rates that are currently in effect, GRATs remain an attractive estate planning strategy. Also, the 2010 Act does not include restrictions on how interests in family-controlled businesses and other entities are valued. Minority interests in family business entities and non-marketable assets will continue to be valued for, transfer tax purposes using the methods that have historically been applied in determining the values for such interests.

### **2010 Act – Temporary Relief Until January 1, 2013**

The provisions of the 2010 Act are only temporary; they are set to expire on December 31, 2012, and it is not yet known if they will become permanent at that time or if additional legislative changes are forthcoming. As a result, the 2010 Act provides little additional guidance for planning beyond 2012. If Congress does not address these issues again before December 31, 2012, for decedents dying after that date, the estate tax rate will again rise to 55 percent with a 5 percent surcharge on certain large estates, and the estate tax, gift and GST exemptions will be reset at \$1,000,000. In the interim, however, meaningful planning opportunities are available.

The following chart illustrates the applicable rules for various effective dates contained in the new law:

	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
Estate Tax Exemption	\$5,000,000, or may elect to have no federal estate tax and "carryover basis" for a decedent that passed away in 2010	\$5,000,000 (plus portability)	\$5,000,000 (plus portability)	\$1,000,000
Basis adjustment upon death	Basis of assets are adjusted or "stepped-up" or down, to the date of death value; may elect "carryover basis" and allocate \$3,000,000 increase to spouse and \$1,300,000 increase to others	Basis of assets are adjusted or "stepped-up" or down, to the date of death value	Basis of assets are adjusted or "stepped-up" or down, to the date of death value	Basis of assets are adjusted or "stepped-up" or down, to the date of death value
Lifetime Gift Tax Exemption	\$1,000,000	\$5,000,000 (plus portability)	\$5,000,000 (plus portability)	\$1,000,000
GST Exemption	\$5,000,000	\$5,000,000	\$5,000,000	\$1,000,000

Maximum estate, gift and GST tax rate	35% (but 0% GST tax in 2010)	35%	35%	55%
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