



The Wealth Advisor

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- **HIGHLIGHTS OF THE NEW ESTATE TAX LEGISLATION**

Highlights of the New Estate Tax Legislation

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act"). In a nutshell, it did five things: extended current unemployment benefits to 99 weeks, extended current income tax rates (the Bush tax cuts) for all taxpayers for two more years, made significant changes to the estate tax applicable to those dying in 2010, 2011, or 2012, modified the gift tax for 2011 and 2012, and modified the Generation Skipping Transfer Tax for 2010, 2011, and 2012.

In this edition of *The Wealth Advisor*, we will look at how these temporary changes can affect your estate planning.

ESTATE TAX EXEMPTION AND TAX RATES

Your estate will have to pay federal estate taxes if its net value when you die is more than the exempt amount in effect at that time. For 2010, 2011 and 2012, the individual exemption is now \$5 million and the tax rate is 35%. So, if someone dies in 2010, 2011 or 2012 and their taxable estate is less than \$5 million, no estate taxes will be due (assuming none of the exemption was used during life to make gifts). If the taxable estate is more than \$5 million, the excess over \$5 million will be taxed at 35%. Those who are married and have planned ahead can use both exemptions (more on this later).

Planning Tip: To determine your current taxable estate, add the value of all your assets, including your home, business interests, bank accounts, investments, IRAs, retirement plans and death benefits from your life insurance policies, and then subtract all of the debts you owe.

It's important to remember two things: These changes are only effective for the next two years. If Congress does not act again before the end of 2012, on January 1, 2013, the estate tax exemption will drop to \$1 million (adjusted for inflation) with a top tax rate of 55%. Also, some states have their own death tax, so your estate could be exempt from federal estate tax but still have to pay a state death tax.

OPTIONAL RETROACTIVE PLANNING FOR ESTATES OF THOSE WHO DIED IN 2010

As noted above, the new law retroactively reinstated the estate tax for all of 2010. However, the Executor for anyone who died in 2010 has the option of electing to use the law as it existed before the 2010 Tax Act and pay no estate tax but have a "modified carryover basis" instead of adjusting the basis of all assets to the date of death value (including, in community property states, the surviving spouse's interest).

The "basis" of an asset is the value used to determine gain or loss for income tax purposes when the property is sold. If you give someone an asset while you are alive, it keeps your basis (what you paid for it) so the recipient gets what is called a "carryover" basis.

For 2010, under the pre-2010 Tax Act law limits were placed on the amount of asset basis that could be stepped up in a decedent's estate: only \$1.3 million in asset value increases were allowed, plus an additional \$3 million of basis increases for assets passing to a surviving spouse. In effect, the law substituted paying capital gains taxes for paying estate taxes. Under the 2010 Tax Act, there is a choice for those who died in 2010.

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Planning Tip: Executors have until September 17, 2011, to decide if the option is better for the estate, file an estate tax return, pay taxes and make any disclaimers. Electing the “no estate tax/modified basis option” would generally be good for those with large estates that would not be covered by the \$5 million exemption. However, each case must be evaluated individually, considering, for example, the amount of estate tax that would be payable now versus income tax that would be due on the gain when the assets are sold at some point in the future; the expected sale date of the assets; and what the capital gains and ordinary income tax rates might be in the future.

PORTABILITY OF ESTATE TAX EXEMPTIONS BETWEEN SPOUSES

The estate tax law provides an unlimited deduction for assets left to a surviving U.S. citizen spouse. Therefore, the first spouse who dies can leave everything to the surviving U.S. citizen spouse and no estate taxes will be due upon the first death. Most married couples like this arrangement because it's easy to administer and all of the assets are available to the surviving spouse. For those who died before January 1, 2011, and for those whose surviving spouses live beyond December 31, 2012, however, a big problem can occur because the estate tax exemption that could have been used at the first death is not available to shield assets in the surviving spouse's estate.

For those couples in which both spouses die between January 1, 2011, and December 31, 2012, the Congress tried to sort of fix this problem with something called “portability.” Under the 2010 Tax Act, if one spouse dies in 2011 or 2012, the Executor of the deceased spouse's estate may transfer any unused federal estate tax exemption to the surviving spouse by so electing on a timely filed estate tax return. But, the transferred exemption must be used before December 31, 2012, or it is lost. Also, only the most recent deceased spouse's unused exemption may be used by the surviving spouse, which could impact the surviving spouse's decision to remarry.

For example, let's say that after Jack dies, Jill marries Bill. If Bill dies before Jill does, Jack's unused exemption would no longer be available to Jill. And Bill may have little or no unused exemption to transfer to Jill.

Even with temporary portability, relying on the unlimited marital deduction can cause other problems. For example, by leaving everything to Jill, Jack has no control over how his share of their estate is managed or distributed. Jill can do whatever she wants with the assets, including disinheriting their children by leaving everything to a new husband or disinheriting any children Jack may have from

a previous marriage. Also, any growth on the assets will be included in Jill's estate when she dies and will be taxed at the rate in effect at that time. (Remember, the estate tax exemption will be just \$1 million with a 55% maximum tax rate in 2013 unless the Congress acts.)

If Jack and Jill plan ahead, they can make sure they use both of their exemptions. Their wills or living trusts could include a provision that splits their \$10 million estate into two trusts of \$5 million each. When Jack dies, his trust uses his \$5 million exemption and when Jill dies, her trust uses her \$5 million exemption. This reduces their taxable estate to \$0, letting them leave the full amount to their beneficiaries. (This tax-planning provision is often called an A-B trust or credit shelter trust.)

There are other benefits to this planning. For example, Jack can keep control over how his share of their estate is managed. He can choose his own beneficiaries, which may or may not be the same as Jill's. The assets in his trust are valued and taxed only when he dies, so any growth on these assets will not be included in Jill's estate when she dies. And even though the assets remain in Jack's trust, they still can be available to provide for anything Jill needs.

Planning Tip: The portability provision may work fine for some couples. But you may still prefer the benefits of the A-B (credit shelter) trust, especially if you have a “blended” family. Also, if you use a living trust and properly fund it (transfer your assets to it), you will avoid probate which, depending on where you live, could save your family thousands more.

GIFTING IN 2011 AND 2012

For 2011 and 2012, the gift tax exemption is \$5 million per person (\$10 million for a married couple), with the tax rate above the exemption at 35%. This exemption is unified with the estate tax exemption, so any unused amount can be transferred to the surviving spouse under the portability provision.

You can still make annual tax-free gifts of \$13,000 (\$26,000 if married) to as many individuals as you wish each year. (This amount is tied to inflation and is adjusted from time to time.)

If you give more than this, the excess is considered a taxable gift and goes against your lifetime gift/estate tax exemption. (\$5 million through 2012, \$1 million thereafter)

GENERATION SKIPPING TRANSFERS IN 2011 AND 2012

A generation skipping transfer occurs when some or all of your estate goes directly to a grandchild or a non-relative who is more than 37.5 years younger than you.

This can happen intentionally: for example, if you skip the living parent (your child) and leave an inheritance directly to your grandchild, that is a generation skipping transfer. It can also happen unintentionally: for example, if an inheritance is in a trust for your child, he or she dies after you but before receiving the full amount and, under the terms of the trust, your grandchildren will receive their parent's remaining inheritance. That, too, is a generation skipping transfer.

Skipping a generation can cause the inheritance to be subject to the "generation skipping transfer" (GST) tax. The onerous GST tax is equal to the highest federal estate tax rate in effect at the time of the transfer and is *in addition to* the federal estate tax. This tax exists because Uncle Sam wants the estate tax to apply when assets are transferred at every generation. So, if you skip a generation, you don't skip the taxes that would have been paid.

For 2010, the GST tax exemption was \$1 million with a 0% tax rate, because there was no estate tax. In 2011 and 2012, the GST tax exemption is \$5 million (\$10 million if you are married and you plan ahead) with a 35% tax rate.

Planning Tip: Remember, there is a possibility that Congress will *not* act before the end of 2012, and the GST tax exemption will decrease in 2013 to \$1 million with a 55% tax rate. With this in mind, if you have a large estate, you may want to use a good portion (or all) of your \$5 million GST tax exemption (\$10 million, if married) in 2011 and 2012

PLANNING OPPORTUNITIES IN 2011 AND 2012

Being able to give up to \$5 million (\$10 million, if married) will allow many individuals to transfer as much as they would want to family members without having to worry about gift taxes. For those with larger estates, planning opportunities abound during this two-year period and, when combined with leveraging strategies, allow for huge amounts of wealth to be transferred. For example:

Grantor Trusts

Using a grantor trust will allow you to transfer substantial additional amounts out of your estate over time. After transferring assets to the grantor trust, you still have to pay the income tax on the trust income, which further reduces your estate. And, by not having to pay the income tax, the trust assets can grow faster. In effect, every extra dollar of income tax you pay is a dollar transferred to the grantor trust.

Leveraging Transfers through Discounts

Quite often, the value of transferred assets can be discounted due to a lack of control and lack of marketability. For example, if you transfer assets to a family limited partnership or limited liability company that you control, an outside buyer would pay substantially less than asset value for shares that have no

Test Your Knowledge with This True or False Quiz

1. Everyone has to pay estate taxes when they die. *True or False*
2. The estate tax exemption was set permanently at \$5 million with a 35% tax rate. *True or False*
3. Basis is the value used to determine estate taxes. *True or False*
4. If an estate does not have to pay federal estate taxes, it will not have to pay any state death tax. *True or False*
5. If Congress does not act by the end of 2012, the current estate tax exemption and rate will stay in effect. *True or False*
6. For those who died in 2010, their estates did not have to pay any federal estate tax or capital gains tax, and all of the assets received a stepped-up basis. *True or False*
7. The new provision for portability of the estate tax exemption between spouses occurs automatically; nothing needs to be done. *True or False*
8. The unlimited marital deduction lets you leave everything to your spouse and no estate taxes will ever be due. *True or False*
9. I can leave my grandchildren an unlimited amount of assets when I die completely tax-free because the IRS considers grandchildren to be special. *True or False*
10. The top income tax rate and long-term capital gains tax rate increased to 39.5% for 2011. *True or False*

Answers: All of the above are false.

say in how the business is run and that cannot be sold without your approval. Discounting values through planning strategies like this can leverage your \$5 million exemption and further increase its value.

Life Insurance

A very large amount of life insurance can be purchased with \$5 or \$10 million. If structured properly, the insurance proceeds can pass free of probate, income and estate taxes to younger generations.



OTHER ITEMS OF INTEREST

- Individual income tax rates will remain at current levels for two more years. If no action had been taken, the top income tax rate would have increased from 35% to 39.6%.
- Tax on long-term capital gains and qualified dividends remains at 15% for two more years. If no action had been taken, capital gains would have been taxed at 20% and dividends would have been subject to the individual ordinary tax rates.

Planning Tip: The danger of the Congress not extending those tax rates beyond 2012 is significant. Remember that the justification for not allowing income tax rates to increase at the end of 2010 was the state of the economy. If the economy is improved as the end of 2012 approaches, those reasons will not exist.

- The AMT (alternative minimum tax) exemption for a married couple was increased from \$45,000 to \$72,450.

CONCLUSION

Now is the perfect time to move forward with your estate, retirement and disability planning. The 2010 Tax Act provides tremendous planning opportunities to transfer vast amounts of wealth for families with estates of all sizes, but it is a limited time opportunity that expires on December 31, 2012. At the same time, individuals with estates of less than \$5 million and married couples with estates of less than \$10 million can focus on planning that concentrates on family goals and objectives without, at least for the next two years, having to jump through hoops to avoid federal estate taxes. Of course, state death taxes and income taxes must still be considered.

We are ready to help you define your personal and financial goals and desires, and take advantage of these unique planning opportunities. Contact our office for a consultation.

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