Estate Planning Insights

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Karen S. Gerstner & Associates, P.C.
Attorneys at Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
(713) 520-5205

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THE NEW TAX LAW AND WHAT IT MEANS-PART ONE

Two weeks before the end of 2010, a new tax law was enacted. The new law is a "good news-bad news" situation in that nearly all of its provisions are favorable to taxpayers, but it expires on December 31, 2012. While the new law provides some big opportunities for making lifetime gifts in 2011 and 2012, in order to "lock in" the very favorable estate tax exemption and rate provided for in the new law, a person would have to die within the next two years, which we don't recommend. Thus, if the new Congress doesn't provide some "permanent" rules, we will soon be "back to where we were before" (sounds like the title of a country-western song).

The New Tax Law. On December 17, 2010, President Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (we will simply refer to this as "the new law"). Here is a quick summary of the new law:

Estate Tax Exemption Amount for 2010: $5,000,000 (this is the "default" rule; however, the executor of a 2010 decedent's estate may "elect out" of the default rule)

Estate Tax Exemption Amount for 2011 and 2012: $5,000,000

Estate Tax Rate for 2010, 2011 and 2012: 35%

Lifetime Gift Tax Exemption Amount for 2011 and 2012: $5,000,000

Gift Tax Rate for 2011 and 2012: 35%

GST Exemption Amount for 2010, 2011 and 2012: $5,000,000

GST Tax Rate for 2011 and 2012: 35%

Reinstatement of "Charitable IRA Rollover" for 2010 and 2011 (i.e., allowing a direct distribution from an IRA to charity of up to $100,000 in one year)

Top Income Tax Rate for 2011 and 2012: 35%

Long Term Capital Gains Tax Rate for 2011 and 2012: 15%

Income Tax Rate on Qualified Dividends for 2011 and 2012: 15%

Introduction of New Technique: Portability of estate and gift tax exemptions (but not GST exemption) between spouses, beginning January 1, 2011

ITEMS NOT CHANGED OR AFFECTED BY THE NEW LAW:

Lifetime Gift Tax Exemption Amount for 2010: $1,000,000 (NO CHANGE)
Gift Tax Rate for 2010: 35% (NO CHANGE)
GST Tax Rate for 2010: 0% (NO CHANGE)
2011 Annual Gift Tax Exclusion Amount: $13,000 (NO CHANGE)

MAJOR PROBLEM WITH NEW LAW: The new law only applies through December 31, 2012

The Default Rule for 2010 Decedents. The good news about the new law is that the estate tax and related income tax basis rules for "middle class" decedents who died in 2010 have been changed to something *better* than what the previous law provided. By referring to "middle class" estates, we mean estates valued at $5,000,000 or less.

Under the "old law" that applied in 2010 until passage of the new law, there was no estate tax for decedents who died in 2010, regardless of the size of the estate, but appreciated assets owned by the decedent did not receive the unlimited and "automatic" step-up in income tax basis allowed under prior law. Instead, a "modified carryover basis" regime applied. Under the old law, the amount of step-up in basis that could be elected was limited: $1.3 million for any decedent, plus an additional $3 million for decedents making qualified gifts to a spouse at death. Further, under the old law, the amount of work required to obtain the limited step-up in basis could be substantial: (i) the Executor first had to obtain sometimes hard-to-find historical basis information for all appreciated assets, (ii) then had to decide which particular assets to elect to step-up the basis of (not always easy when different beneficiaries are receiving different assets from the decedent–imagine an estate split between a second spouse and children from a prior marriage), and (iii) then had to prepare and file a special tax return to obtain the limited basis step-up available for a decedent dying in 2010.

The "default rule" under the new law for decedents who died in 2010 is that the estate tax *applies,* at a 35% rate, but every such decedent has an estate tax exemption amount of $5,000,000. Plus, there is an "automatic" (and unlimited) step-up in income tax basis for all appreciated assets in which the decedent owned an interest at death. Thus, in the case of a decedent who died in 2010 with an estate (including adjusted taxable gifts) not exceeding $5,000,000, the default rule under the new law clearly provides a better result than what the old law provided: no estate tax and a complete step-up in basis for all appreciated assets without having to complete and file a complicated form (or a federal estate tax return).

For a married decedent who was living in Texas at the time of his death, this step-up in basis applies to *both halves* of the community property. In the case where no estate taxes have to be paid as a result of the decedent's death (either because the decedent's estate was less than $5,000,000 in value and/or because the estate tax marital deduction applied to defer estate taxes until later), this is a "tax-free" step-up in basis–something that is rarely allowed by the tax laws and very valuable. Beneficiaries of a decedent's estate would rather inherit assets that have a tax basis equal to date of death value versus the decedent's original tax basis (e.g., the original purchase price) because the higher tax basis reduces the amount of capital gain on later sale of the inherited asset.

The Executor of the estate of a very wealthy decedent who died in 2010 can opt out of the default rules described above and instead go back to the rules in effect for 2010 prior to passage of the new law. This election out of the default rule is available for the estate of a decedent who died any time during 2010, not just for those who died prior to enactment of the new law. Obviously, in the case of a 2010 decedent whose estate was worth tens of millions, hundreds of millions or even billions of dollars at death, it would be better for the Executor to elect out of the default rules and go back to the old rules which provided for no estate tax at all, even though the beneficiaries will have mostly a "carryover basis" (i.e., a non-stepped-up basis) in the assets they inherit from the decedent.

The Transfer Tax Laws for 2011 and 2012. Another part of the new law is that, for the next two years (2011 and 2012), the estate tax exemption amount will be $5,000,000. Of course, as noted above, a person has to die in one of those years to "lock in" that amount. On the other hand, the lifetime gift tax and GST exemptions are both also $5,000,000 for the next two years, with a 35% tax rate. The higher exemption amounts and relatively low tax rate make gifting during the next two years very attractive. Further, since the applicable federal rates are still very low, a significant amount of wealth can be transferred over the next two years with little or no transfer tax, especially if certain "leveraged" transactions are used. We plan to discuss more lifetime planning options in future newsletters (*see also*, however, our previous newsletters dated 4/30/2010 and 7/31/2010, discussing the use of intentionally defective grantor trusts [IDGTs] to transfer significant amounts to desired beneficiaries, at www.gerstnerlaw.com/reference.asp).

Portability of Exemptions Between Spouses. Another feature of the new law is a provision we've never had before: portability of exemptions between spouses. This feature of the new law applies starting in 2011. Portability is possible for both the estate tax and gift tax exemptions (although the rules differ somewhat). It is not available for the GST exemption. Only the most recently deceased spouse's unused exemption can be used by the surviving spouse. The theory is this: if the first spouse dies leaving everything he owns to the surviving spouse (so that none of his estate tax exemption amount is utilized at the time of his death due to the marital deduction), assuming all requirements are met, on the surviving spouse's death, she can "tack on" to her own estate tax exemption amount the unused estate tax exemption of her deceased husband. Thus, theoretically, if portability applies and each spouse has a $5,000,000 estate tax exemption amount on his/her respective death, married couples with a combined estate of $10,000,000 or less would no longer need to create and fund a Bypass Trust on the first spouse's death in order to avoid paying estate taxes on the second spouse's death. *The above is an oversimplification of the actual rules, however, which contain some traps for the unwary.*

First, in order for portability to apply, the Executor of the estate of the first spouse to die *must* file a federal estate tax return (Form 706) to make the portability election. This is true even if the first spouse's estate would not otherwise be required to file a Form 706. Many practitioners are hoping that the IRS will authorize and create a simpler form that can be filed by the Executor, instead of a Form 706, if the sole purpose of filing is to elect portability; however, to date, no simpler form has been announced or promulgated. Thus, the cost of portability is the cost of preparing and filing a federal estate tax return for the first spouse's estate, which is not insubstantial. Plus, the risk is that an Executor may "blow" the portability election if he fails to file the return in a timely manner. If the Form 706 isn't filed, then portability is "lost", and the Executor may be held liable for a breach of fiduciary duty if estate taxes are paid later.

In addition, the surviving spouse must be careful about remarrying after the first spouse's death because the estate tax portability option only applies to the most recently deceased spouse (this has been referred to as the "privity" requirement). Thus, if a husband dies leaving everything to his wife and the Executor of the husband's estate files a Form 706 to elect portability, so that the wife would have her deceased spouse's unused exemption amount in addition to her own exemption amount to shelter transfers at her death from the estate tax, and then the wife remarries and her new husband dies before she does, leaving everything he owns to his children from his prior marriage (assume this transfer entirely uses up his estate tax exemption amount, so that he doesn't have any "unused" estate tax exemption), the wife is now back to having only her own exemption from the estate tax when she dies. In other words, the wife "gave up" the first husband's unused exemption amount when she remarried and her new husband predeceased her, leaving no unused exemption amount.

Another "trap" with the estate tax portability rules is that if Congress later decreases the estate tax exemption amount (or does nothing, so that the estate tax exemption amount for 2013 and beyond is only $1,000,000), the deceased spouse's unused estate tax exemption amount is reduced, accordingly (of course, the surviving spouse's estate tax exemption amount would also be reduced to whatever it is in the year of her death).

The gift tax portability rules are slightly different in that the amount of gift tax exemption available to a surviving spouse is determined as if the surviving spouse had died on the last day of the year. In essence, under the gift tax portability rules, a surviving spouse could end up using the unused exemption amount of more than one deceased spouse.

A surviving spouse may wish to use her recently deceased husband's unused estate tax exemption amount to make gifts during life *before* she remarries and runs the risk of her new husband predeceasing her with no unused exemption (and before the exemption amount decreases due to Congressional action or inaction). Of course, if the estate tax exemption amount decreases by the time of the surviving spouse's death and the surviving spouse has already used up all of her and her deceased spouse's exemption amounts to make lifetime gifts, there could well be estate taxes due on her death with insufficient assets remaining in her estate to pay those taxes. This is a major problem with the portability provision, caused by the uncertainty of the estate tax exemption amount in the future. No one has any idea who would pay the estate taxes in that case, but it's clear that the entire remaining estate could be "wiped out" by estate taxes in a situation like this.

The biggest problem with the new portability feature is that it (like the $5,000,000 exemption amount) only applies through 2012. In other words, portability expires on December 31, 2012, unless the new Congress extends it. Thus, relying on portability to avoid estate taxes on the second spouse's death is **premature** at this point. In other words, portability should probably be viewed more as a "remedial" measure than a planning technique right now. Most couples with a combined estate in excess of $1,000,000 should still consider including some type of Bypass Trust provisions in their Wills, although a simpler version (discussed below) may be sufficient for many couples.

<u>Direct "IRA Rollover" to Charity</u>. In the new law, the provision allowing for a direct distribution from an IRA to a qualified charity was reinstated, effective for tax years beginning after December 31, 2009, through December 31, 2011. To take advantage of this, the IRA owner must be over 70½ years old on the date of the gift. The total amount given to charity from the IRA cannot exceed $100,000 in one year. The IRA owner does not receive a charitable contribution deduction for income tax purposes when he uses this provision. Instead, the amount distributed directly to charity from the IRA counts toward the IRA owner's minimum required distribution ("MRD") for that year (i.e., satisfies all or a portion of the IRA owner's MRD so that the IRA owner does not have to take that amount, personally). Utilizing this provision alleviates any taxable income for the IRA owner on the amount distributed to charity (ordinarily, a distribution from an IRA for *any* purpose constitutes taxable income). The IRA custodian must pay the charity directly (i.e., the IRA owner cannot first withdraw the amount from the IRA and then give it to charity).

A special provision in the new law allowed qualified charitable distributions from IRAs made in January 2011 to be treated as if made in 2010 and to be counted against the individual's *2010* $100,000 charitable distribution limitation (instead of against his 2011 limitation). Doing this would allow the IRA owner to make an additional charitable distribution for 2011 of up to $100,000 from his IRA. Since the new law became effective so late in 2010, however, most IRA owners had already taken their MRD for 2010 prior to enactment of the new law. The IRS has clarified that already taken 2010 MRDs cannot be put back into the IRA owner's IRA (or rolled into a new IRA) so that a distribution can then be made from the IRA directly to charity for the 2010 tax year. Thus, a person who already took his 2010 MRD before December 31, 2010, cannot now direct it to charity. An IRA owner who didn't take her 2010 MRD before December 31, 2010 could direct it all to charity in 2011 and, if done before February 2011, such a distribution can be treated as a 2010 distribution.

KAREN S. GERSTNER & ASSOCIATES, P. C.
A Professional Corporation
Attorneys at Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448

Telephone: (713) 520-5205
Fax: (713) 520-5235

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Current Estate Planning Considerations. Unfortunately, right now, we do not know whether the new Congress will make the $5,000,000 estate tax exemption amount "permanent". If the new Congress does nothing, the estate tax exemption amount for decedents who die *after 2012* will revert back to (only) $1,000,000 and the estate tax rates will revert back to 41% to 55%. We also don't know whether portability will become "permanent". *If* both portability and the $5,000,000 exemption amount become permanent, then married couples with $10,000,000 or less will not have to create a Bypass Trust to avoid estate taxes (assuming the surviving spouse doesn't remarry and lose the first spouse's exemption, as explained in the example above). Because so much about the future is unknown, most couples with estates between $1,000,000 (the 2013 estate tax exemption amount per the law right now) and $5,000,000 (the 2011 and 2012 estate tax exemption amount) are creating Wills with an *option* for a Bypass Trust. This type of Will is often called a "Disclaimer Will" because a *disclaimer* is used to exercise the option. A Disclaimer Will is a "cut above" a simple Will, because it gives couples the option to create a Bypass Trust, if needed, while not "locking them into" a Bypass Trust, if not needed. It is less complex than a "formula" or "automatic" Bypass Trust Will. Right now, for couples with more than $1,000,000, the prudent thing is to use Disclaimer Wills until we know more about the future tax laws. Of course, couples with more than $5,000,000 should still use "formula" Bypass Trust Wills in nearly all cases.

In our next newsletter, we will discuss in much greater detail the advantages and disadvantages of married couples using a Bypass Trust versus relying on the portability option. We will also compare and contrast the "formula" Bypass Trust approach with the "optional" Bypass Trust approach. Stay tuned!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above. You can also reach us by email addressed to:

Karen S. Gerstner*	karen@gerstnerlaw.com
Rebekah Lorenz	rebekah@gerstnerlaw.com
Sharon Riccucci	sharon@gerstnerlaw.com
Biljana Salamunovic	biljana@gerstnerlaw.com
General Delivery	info@gerstnerlaw.com

*Board Certified, Estate Planning & Probate Law, Texas Board of Legal Specialization