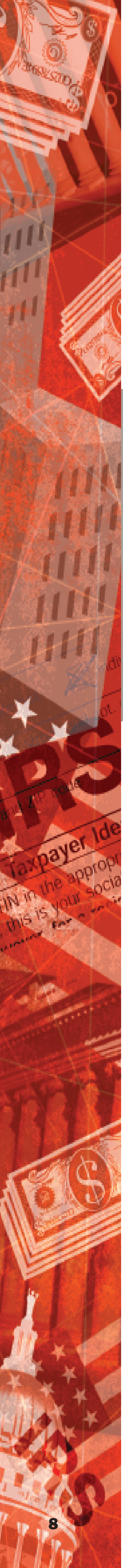

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Changes in Federal Wealth Transfer Tax Laws

The tax rules concerning estate tax, gift tax, and generation-skipping transfer tax are in an unusual state of limbo as the current temporary provisions phase out without any new provisions in place. This uncertainty requires careful consideration in estate tax planning, for example, with estate tax portability and lifetime gifts.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) reformed the federal transfer tax system that includes estate tax, gift tax, and generation-skipping transfer tax (GSTT). Under EGTRRA, by 2009 the lifetime exemption equivalents for estate tax were increased to \$3.5 million, and the top marginal tax rates were reduced to 45%. In addition, EGTRRA provided for no estate tax or GSTT in 2010. Because of a sunset provision contained in the Act, starting on January 1, 2011, the lifetime exemption equivalents and tax rates would revert to pre-2002 levels, that is, \$1 million and 55% highest marginal rate, respectively. Congress planned to have new provisions in place before 2010, but, after many efforts, no revisions were made prior to 2010.

In December 2010, Congress passed the 2010 Tax Relief Act (2010 TRA), which broadly changed the estate, gift, and GSTT tax rules for 2010-2012. But TRA also sunsets in 2013, thereby providing only a temporary fix. If Congress doesn't make any further changes to the law, starting in 2013 the estate tax exemption equivalent amount will return to the 2001 level of \$1 million, and the top marginal tax rate will return to 55%. Important provisions of the TRA are the changed 2011/2012 exemption equivalent (\$5 million) and tax rates (maximum marginal tax rate of 35%). The GSTT exemption amount is also determined with reference to the estate tax exemption equivalent.

Donors of lifetime gifts can continue to apply the annual gift tax exclusion before having to use part of their exclusion equivalent. For 2011, that inflation-adjusted annual exclusion amount for present interest gifts is \$13,000 per donee per donor per year. Married couples may continue to "split" their gift and may exclude combined gifts of \$26,000 to each donee. The \$5 million exemption equivalent can expand the amount of nontaxable gifts well beyond annual exclusion gifts. Because of the temporary nature of the \$5 million exemption equivalent, it's important to consider what happens when a taxpayer uses the exemption equivalent in 2011 or 2012 and then dies after the exemption possibly has been reduced to \$1 million upon the sunset of the 2010 TRA provisions.

Estate Tax Portability

The 2010 TRA provides for "portability" between spouses of the estate tax applicable exclusion amount. This allows a surviving spouse to elect to take advantage of the unused portion of the estate tax applicable exclusion amount of his or her deceased spouse, thereby providing a larger exclusion amount. A "deceased spousal unused exclusion amount" would be available to the surviving spouse only if an election is made on a timely filed estate tax return. This election will sunset on January 1, 2013.

To illustrate, let's assume John and Jane are married, have all of their assets jointly titled, and their net worth is \$8 million. John dies first, but his estate won't need to use any of his \$5 million estate tax exemption because all of his assets are jointly titled with Jane. If John desires that his share of the joint assets be transferred to Jane, the unlimited marital deduction allows that to happen without incurring any federal estate taxes. If the estate is still worth $8 million at the time of Jane's later death, however, she can only pass on $5 million free from federal estate taxes if there is no portability. The remaining $3 million of taxable estate would be taxed at 35%. Therefore, Jane's estate would owe $1.05 million in estate taxes after her death.

With portability, assuming the same facts as above, John's unused $5 million estate tax exemption will be added to Jane's $5 million exemption, in turn giving Jane a $10 million exemption. Since Jane has "inherited" John's unused estate tax exemption, she can pass on $10 million free from federal estate taxes at the time of her death, and Jane's $8 million estate won't owe any estate taxes at all. Thus, portability of the estate tax exemption will save John's and Jane's heirs $1.05 million in estate taxes.

With the election and careful estate planning, married couples can effectively shield up to $10 million from estate tax by each spouse maximizing his or her $5 million applicable exclusion equivalent. Because this provision is scheduled to sunset after 2012, the utility of the portability election is currently limited to situations where both spouses die in 2011 or 2012. Portability can effectively render significant estate tax planning unnecessary and avoid all estate taxes on both estates for couples whose total taxable estates are between $5 million and $10 million.

Lifetime Gift Clawback

No one really knows what will happen between now and 2013, but currently one of the main areas for action by wealthy individuals is to make lifetime gifts in 2011 and 2012 when the exclusion equivalent is $5 million. This approach will minimize current gift tax. It's possible that Congress will make this exclusion equivalent permanent, but it's also possible that it will be made permanent at a lower amount, such as $3.5 million, or drop back to $1 million. But a donor's use of the gift tax exclusion equivalent in making lifetime gifts will be recaptured in the form of additional estate taxes if and to the extent that the amount of gift tax exclusion used by the donor exceeds the donor's basic exclusion amount at the time of the donor's death. Such a recapture is sometimes referred to as a "clawback."

To illustrate, assume a donor uses his full $5 million gift tax exclusion in 2011 and 2012, and the 2010 TRA sunsets just after midnight on December 31, 2012. If the donor dies in 2013, the donor's estate will pay increased estate taxes, reflecting the difference between the $5 million gift tax exclusion equivalent used and the $1 million applicable exclusion equivalent amount available at the donor's death.

This recapture potential exists because the estate tax is imposed on the decedent's taxable estate as increased by the decedent's post-1976 adjusted taxable gifts, less the gift tax payable on prior gifts and unified credit (tax on the exclusion equivalent amount at the donor's death). Accordingly, to the extent that the donor's taxable gifts were sheltered from gift tax by a gift tax exclusion equivalent that's larger than the applicable exclusion equivalent amount at the time of the donor's death, such gifts will become taxable in the donor's estate.

A donor who uses the $5 million gift tax exclusion equivalent in 2011 or 2012 should consider including a provision in his or her will indicating who should bear the increased estate tax costs that arise as a result of these gifts, particularly if the applicable exclusion equivalent amount is later reduced. In the absence of such directions, it's generally unclear how these taxes will be apportioned.

Clearly the uncertainty and the economic consequences of estate tax law changes are high. At one extreme, the federal estate tax exemption equivalent could be reset at $1 million with a 55% top marginal tax rate, and at the other extreme the tax could be repealed again. Other potential changes may either temporarily or permanently extend the 2010 TRA rules or return to the 2009 level rates and exemptions (i.e., 45% top marginal tax rates, $3.5 million estate tax exemption equivalent) with or without portability. Therefore, it may be prudent for taxpayers to perceive the 2010 TRA as a limited opportunity. Unless the planner has a perfect crystal ball that reveals the exact date of a client's death, the estate plan must provide for a death in 2011 or 2012. The plan must

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also provide sufficient flexibility to adjust for the post-2012 periods when the laws for those periods become known. **SF**

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