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January 2011 SPECIAL CLIENT UPDATE EDITION:

Our Summary of the Temporary Tax Relief for Estate, Gift and Generation Skipping Transfer (GST) Taxes Under The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

(1) The estate tax was retroactively reinstated effective January 1, 2010 with a $5,000,000 exemption and a 35% tax rate.

(2) The gift tax exemption remained at $1,000,000 for 2010 with a 35% tax rate.

(3) The estate and gift tax system has been reunified beginning January 1, 2011 with a $5,000,000 combined exemption and a 35% tax rate.

(4) Generation skipping transfers also have a $5,000,000 exemption but beginning on January 1, 2010, with a special 0% tax rate in 2010, only. After December 31, 2010, the tax rate is 35%.

(5) For 2010, only, there is a special election that allows the decedent's estate to elect out of estate taxation, but must then use the modified carryover basis regime for the tax cost basis, rather than the stepped-up basis.

(6) The new law allows portability for surviving spouses dying after December 31, 2010. This means that if the first spouse to die does not use up all of his or her $5,000,000 exemption, then the surviving spouse can use his or her own $5,000,000 exemption, plus the remainder of the exemption of the first spouse to die. However, this requires timely affirmative action by the executor of the estate of the first spouse to die, in order for the surviving spouse to be able to use the exemption.

(7) The exemption amount is indexed for inflation beginning in 2012.

(8) The new law is temporary and only lasts through December 31, 2012; at which time, we revert back to the pre-Bush Tax Cuts and the $1,000,000 combined exemption for estate and gift taxes and no portability. This also assumes that Congress does nothing further.

A More Detailed Discussion

Estate Taxes Have Been Reinstated for 2010, but with a $5,000,000 Exemption and Portability

What we have is a retroactive reinstatement of the estate tax effective January 1, 2010 with a $5,000,000 per person exemption from estate taxes. With a married couple, if the first spouse to die does not use all of his or her exemption, then the surviving spouse is allowed to use what was not used of the first spouse's $5,000,000 exemption, along with the survivor's own exemption.

This is called "portability" and can provide up to a $10,000,000 exemption for married couples, if the surviving spouse dies after December 31, 2010. However, this only applies for two (2) years. In order to receive the benefit of the $10,000,000 in exemptions, both spouses have to die prior to January 1, 2013, unless Congress extends “portability”. Therefore, we have the continued uncertainly with respect to estate planning.

Do not be lulled to sleep by the $5,000,000 exemption and possible $10,000,000 with portability.

You may over fund one of your postmortem trusts.

If you are married and have trust agreements that were drafted by us prior to January 1, 2002 or possibly later that have a formula clause which creates a Trust A (Marital Deduction Trust) or a QTIP Trust in conjunction with a Trust B (Credit Shelter Trust), which the vast majority of trusts did, then you are likely tying up more assets in the more restrictive Trust B than is necessary. This means that your surviving spouse may be unnecessarily deprived of the free use and enjoyment of your assets.

Also, if you included children as beneficiaries of the Trust B (Credit Shelter Trust) along with your surviving spouse, then there will likely be no funds that your surviving spouse will have unrestricted access to.

If you included children either from your current marriage or previous marriage or some other beneficiary who is not your surviving spouse, then your surviving spouse may not have access to any of your funds, if you die.

There can be similar problems if you have Generation Skipping Transfer (GST) Trusts. They may be over funded.

If your trust agreements were drafted by another attorney, the problems can even be for dates after January 1, 2002.

There are many permutations and combinations of problems that can occur. If you have any questions, you should come in to have your documents reviewed as soon as possible.

We have been sending out the same message for nearly 10 years now, and many of our clients are still not listening

What Will Happen When the “Extension” Expires on January 1, 2013?

The new law is only good through December 31, 2012. The question is what will happen beginning January 1, 2013? Will Congress keep it as is, go back to the $1,000,000 pre-Bush Tax Cut exemption, make it higher or lower than $5,000,000, or increase or decrease the tax rates? Although logic and politics usually dictate that Congress will not reduce the exemptions or increase the tax rates, once they have given the benefit, no one knows for sure.

However, keep in mind that Congress already reduced the benefits because for 2010 there was, up until this law was passed, no estate or generation skipping transfer tax. For 2010 there is now an estate tax, and a generation skipping transfer tax. The good news is that each has an exemption of $5,000,000.

There is also a special 0% tax rate for generation skipping transfer (GST) taxes for 2010. The gift tax exemption remains at $1,000,000 for 2010 with a 35% tax rate.

Although, the new legislation was hailed as an extension of the Bush Tax Cuts, the portion relating to estate taxes is actually a substantial tax increase, not a decrease. That is, unless you compare it to what we would have gone back to, which is a $1,000,000 estate tax exemption, if Congress had done nothing. More good news is that the new law reduces the gift tax by increasing the exemption to $5,000,000 in 2011.

Reunification of the Estate and Gift Taxes

A significant change is that the estate and gift taxes have been reunified similar to the manner that they were prior to the Bush Tax Cuts, which means the $5,000,000 exemption is now shared and is both for estate and gift taxes, combined. It also appears to be a somewhat less complex system than it was prior to the Bush Tax Cuts, due to the use of a much higher $5,000,000 exemption and one 35% tax rate for amounts in excess of the exemption.

The original Bush Tax Cuts, often referred to as EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001) bifurcated estate and gift taxes so that we ended up with two separate taxes and two separate exemptions, when finally in 2010 there was no estate or generation skipping transfer tax at all, until the passage of this legislation.

Due to the reunification of the estate and gift taxes, beginning January 1, 2011, you are once again able to either give your property away at death or during life. Either way, you will use up the same $5,000,000 exemption and pay the same 35% tax rate, at least until January 31, 2012.

However, the gift tax may be lower than the estate tax, if a tax is actually paid, because the gift tax is tax exclusive; whereas, the estate tax is tax inclusive. This means that with an estate tax, you are paying a tax on a tax. This also means that it takes more funds to transfer the same amount to the beneficiary at death.

With regard to gifts, individuals still have their $13,000 per donee annual exclusion amount that is adjusted for inflation. This is in addition to the exemption amount.

If we assume that there will be an estate tax to pay, then for those who can afford to make these gifts, it is often more tax efficient to make the gifts during life than to die with the assets. However there can be higher subsequent capital gains taxes when the assets are sold. This also needs to be taken into consideration in any analysis.

Although beyond the scope of this discussion, if a gift is made during life and the fair market value of the asset is less than the basis in the hands of the donor, there can be three different income tax results upon the subsequent sale of the asset by the donee.

New Generation Skipping Transfer (GST) Exemption

The new law also changed the generation skipping transfer tax (GST) exemption to $5,000,000 for 2010, but with a 0% tax. The 0% tax only applies in 2010.

This presents interesting planning opportunities, but the discussion is beyond the scope of this material. However, for those who are very wealthy and can afford large gifts in 2010, this may have been a grand slam home run.

Unfortunately, due to fact that these GST planning opportunities expired on December 31, 2010, it is too late for such planning unless the gifts have already been made. As an emergency procedure, we posted this article on our website on December 24, 2010 with the following notation concerning this type of GST planning: ***ANYONE INTERESTED IN SUCH PLANNING SHOULD IMMEDIATELY CONTACT THEIR ESTATE PLANNING ATTORNEY.***

ANOTHER MATTER OF IMPORTANCE

Make Sure That You Reapply for Your Homestead Exemption and 4% Assessment Ratio if You Placed Your Home into Your Revocable Living Trust

Whenever we do trust planning and recommend that your house be placed into trust, we write to your real estate attorney and copy you on the letter to remind you that you should apply or reapply for the homestead exemption and 4% assessment ratio, if you otherwise are eligible. We also warn you of the risks of higher taxation, which have apparently become even greater with recent substantial increases in taxes that are being imposed locally and statewide, especially if the home is not a primary residence. In addition to our warning, most real estate attorneys will give you the same advice either orally or in writing.

If you have not done so, please apply or reapply prior to January 15, 2011, if you qualify. Otherwise, you will be paying a much higher tax than is necessary.

35% Estate, Gift, and GST Tax Rates

Along with the $5,000,000 exemption, Congress gave us a new maximum estate tax rate of 35%. Under the law as of December 31, 2009, when there was a $3,500,000 exemption, we had a 45% estate tax rate. Prior to the Bush Tax Cuts, the rates were as high as 55% and in some cases even higher.

The 35% rate will apply to estate taxes, gift taxes, and generation skipping transfer taxes, beginning January 1, 2011. The 35% rate already applies to gift taxes.

Although the estate and gift taxes are unified, generation skipping transfer taxes will remain separate. As discussed above, for 2010 only, there is also a special 0% tax rate for generation skipping transfers.

The 2010 Problem - Modified Carryover Basis and The Estate Tax

There is a residual problem for 2010, which is called the modified carryover basis regime. For decedents who died in 2010, a decision needs to be made as to whether or not to opt out of the new estate tax system and then use the modified carryover basis regime.

Under the Bush Tax Cuts, in 2010 when there was not supposed to be an estate tax, there was a new modified carryover basis regime for assets included in a decedent's estate. This was in lieu of the step-up (or step-down) in the tax cost basis to the fair market value of the assets at the date of death when there was an estate tax.

With some exceptions, if you use carryover basis you start with the tax cost basis of the assets just prior to the decedent's death, unless their fair market value is lower, in which case you use the fair market value. The exceptions are beyond the scope of this material.

On the other hand, with a step up in basis, you value the assets at their fair market value as of the date of the decedent's death or the alternate valuation date, if the value on the alternate valuation date reduces both the value of the estate and the estate tax. The alternate valuation date is usually 6 months after the date of death, but there are exceptions not discussed in this material.

With the 2010 modified carryover basis regime you add $1,300,000 to the carryover basis, but only up to the fair market value of the assets. There are also other adjustments, but these are also beyond the scope of this discussion.

For assets passing to the surviving spouse and qualifying for the marital deduction and for certain trusts that also qualify for the marital deduction from estate taxes, such as a QTIP trust, these assets receive another $3,000,000 step up in basis under the modified carry over basis regime.

This means that many estates still receive the equivalent of a stepped up basis using the modified carryover basis; unless, (1) a very large estate is involved, or (2) the assets have an extremely low tax cost basis, or (3) there is no surviving spouse or marital deduction, or (4) all of the above or some combination applies.

The effect of the increase or modification of the tax cost basis is to reduce capital gains when the assets are subsequently sold. Congress wanted decedents' estates or those who receive the assets to either (1) pay an estate tax, presumably increase the tax cost basis and pay lower subsequent capital gains taxes, or (2) they wanted the estate to pay no estate tax, not receive a stepped up tax cost basis and presumably pay higher subsequent capital gains taxes.

It should be noted that neither the modified carryover basis regime nor the step up in basis rules apply to IRAs, 401(k)'s or similar assets, to the extent that they have no tax cost basis. Most do not. These types of assets are also normally subject to ordinary income tax rates rather than capital gain tax rates.

Estate Tax or Tax Cost Basis Relief for Decedent's Dying in 2010

One of the ironies of the modified carry over basis regime and the stepped up basis rules is the assumption that assets are normally worth more at death than they originally cost, assuming the assets had been held for many years. As the last 10 years have taught us, sometimes our original tax cost basis is higher than the value many years later.

For those decedents who died in 2010 with assets that will actually benefit more from the modified carryover basis regime than the step-up in basis value or for those estates that will pay an estate tax, there is relief under the new law. Basically, the estate can elect out of the estate tax system and can treat the estate as though there is no estate tax in 2010, and then use the modified carryover basis regime instead of stepped up basis. Presumably, you have to file a return to do this and you need to make an election.

Where are the Tax Forms for 2010?

Ironically, in past years, it has taken the IRS about 9 months to publish an estate tax return for decedents dying during each new calendar year. It then takes the software providers about another month to update their software and distribute it to tax return preparers. Compare this to income tax returns, where most forms are usually available prior to January of each calendar year.

Since there was no estate tax for 2010 until the bill was signed by President Obama on December 17, 2010, there was no estate tax return needed, so it is not clear how long it will take for the IRS to provide one. This will most likely cause substantial delays.

CPAs Ask for Help From the IRS

The modified carryover basis regime is even creating problems for CPAs. In early December of 2010, The American Institute of Certified Public Accountants (AICPA) sent a letter to the IRS National Office asking for help on the modified carry over basis rules because they did not understand how to apply the law. Some of the points raised in the letter are also why I made one or more of the comments above to the effect that certain subjects are beyond the scope of this discussion.

Decedent's estates that opt out of the estate tax system will use a Form 8939 to report the modified carryover basis to the IRS. It is my understanding that as of the date of this publication, you still cannot go to the IRS website and obtain a copy of the Form 8939 for the modified carry over basis. The Form 8939 is due at the same time that a decedent's final income tax return is due, which for 2010 is April 18, 2011.

Under certain circumstances, there can be a $10,000 penalty for not timely filing the 8939, at least under the law prior to the new legislation. I am not certain how the new law affects the penalty, since you now have to elect out of the estate tax system and into the modified carryover basis regime for 2010, but this issue should certainly be kept in mind.

I also understand that the IRS shared the Form 8939 with certain tax practitioners in November of 2010 to see what they thought, and the forms are floating around, but are still unofficial. I also understand that the form was withdrawn due to problems with the interpretation of the new laws. The AICPA letter would indicate that the form did not help in understanding the law.

On December 16, 2010, the IRS published a Draft Form 8939. However, I only found the form by Googling around the Internet. When I went in the front door of the IRS website, I could not find the form for public dissemination.

Extension of Time to File Returns and Make Elections Under the New Law

The above is a problem for taxpayers who died earlier in 2010 because the normal filing deadlines may be coming up or are already past due. In order to mitigate but not necessarily solve this problem, Congress is giving estates and their advisors 9 months from the date of enactment of the new legislation to file returns and make elections, where applicable. This may not be enough time, but we will see.

Conclusion

This legislation is quite complex. There is a great deal of work that estate planning and tax practitioners will have to do and as with all such new legislation, there is a significant learning curve that takes time. Also, the pressure is on to advise clients as soon as possible on how to proceed.

There will be a substantial amount of post-mortem planning work for something that only affects a small number of taxpayers, and for only 2010 with respect to the modified carryover basis regime, and maybe only two years for the remainder of the estate, gift, and generation skipping transfer tax rules. This will also likely make estate planning less efficient and more costly.

For decedents dying in 2010, for example, the work includes, but is not limited to (1) advice on the modified carryover basis regime; (2) whether to treat the estate as though there is no estate tax in 2010; (3) whether to disclaim assets and create a credit shelter trust to reduce taxes in the future, if a disclaimer trust is being used, or if other reasons exist for making a disclaimer; (4) how much of a qualified terminable interest property (QTIP) election to make, if a QTIP Trust is being used, and (5) whether to make large gifts prior to December 31, 2010 to take advantage of the GST 0% tax rate for 2010; just to name a few. Unfortunately, some of the planning, such as large gifts to take advantage of the 0% GST tax rate for 2010 are already too late.

Estate planners will have to try to take into consideration what we know the law to be through December 31, 2012 and what we believe it may be after that date. This will be a daunting task, at best.