

Estate Planning Bulletin

Congress Finally Resolves Estate Tax Uncertainty: But Only for Two Years!

As part of a compromise to extend the income tax rates in effect from 2003 to 2010 (sometimes described as the “Bush tax cuts”) and unemployment benefits, Congress has finally resolved uncertainties in the estate, gift, and generation-skipping transfer (“GST”) taxes. The new law makes the most significant changes to these taxes since 2001, including a generous increase in exemptions and a significant reduction in tax rates for 2011–2012. **In order to take advantage of some one-time wealth transfer opportunities, action is required before the end of 2010.** For nearly all high-net-worth persons, the next two years will bring extraordinary estate planning opportunities. Unfortunately, and contrary to many media claims, 2011 and 2012 will also bring added complexity and uncertainty. Surprisingly, estate planning for married persons with estates of less than \$10,000,000 may actually be more complicated than planning for married persons with larger estates. Accordingly, all estate plans should be reviewed early in 2011 to determine whether the plan will work as intended under the new tax laws. Persons who would like to discuss how the new estate, gift, and GST tax laws affect their specific situations and existing estate plans should call a member of the Estate Planning Group of Vedder Price P.C.

Executive Summary

The following is an executive summary of the most notable effects of the new law; a more detailed discussion of each can be found inside this Bulletin:

- **Income Tax Rates Continued for 2011–2012.** The 2010 income tax rates are continued for two more years, including the preferential 15% tax rate for long-term capital gains and qualified dividends.
- **Estate Tax Made Optional for 2010.** The estate tax, which had been repealed for 2010, was reinstated effective January 1, 2010, but the executor for a person dying in 2010 may elect to opt out of the estate tax and apply carryover basis instead.
- **Transfer Tax Exemptions Increased, Tax Rate Reduced.** The lifetime exemption amount for transfer taxes—the estate tax, gift tax, and GST tax—is set at \$5,000,000. These increases are effective in 2010 except for the gift tax exemption, which remains \$1,000,000 until 2011. The tax rate on estates, gifts, and generation-skipping transfers above these amounts is 35%.
- **Generation-Skipping Transfer Tax Rate Is Zero for 2010.** For all of 2010 (including the balance of the year), the GST tax rate is zero.
- **Unused Estate Tax Exemption Transferable to Surviving Spouse.** Beginning in 2011, the unused estate and gift tax exemptions of the first spouse to die may be transferred to the surviving spouse for both gift and estate tax purposes.
- **Bullets Dodged.** The new legislation did *not* include recent proposals to reduce or eliminate the effectiveness of several of the most advantageous estate planning techniques.
- **Direct Gifts from IRAs to Charities Reinstated for 2010–2011.** In 2008–2009, IRA owners over age 70½ could make direct distributions from their IRAs to charities and exclude the amount from income while treating it as part of their required minimum distribution. The new law extends that option through 2011. Because so little time remains in 2010, a special rule permits taxpayers to make such a transfer in January 2011 and treat it as if it had been made on December 31, 2010.

The “Tax Relief, Etc.” Act of 2010

The bill passed by Congress and signed by President Obama on December 17, 2010, H.R. 4853, was titled the “Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010” in its final form. (It had previously carried other names, including the “Middle Class Tax Relief Act of 2010.”) For simplification, this Bulletin will refer to it as the “2010 Tax Act” or “the Act.”

The bill went through many changes in the last month prior to enactment, and includes some unexpected provisions while excluding other provisions that had been expected. As a result, **some of our recommendations from prior bulletins have changed**. Please contact a member of our Estate Planning Group for confirmation before acting on our prior recommendations.

The benefits of the Act may be temporary, however. **All of the tax changes included in the Act will expire on or before January 1, 2013**. Without further action by Congress, the estate, gift, and GST tax rates and exemptions applicable on January 1, 2001 will return on January 1, 2013. Additional legislation in late 2012 or early 2013 seems likely, but it is impossible to predict the details of that legislation.

Income Tax Rates Continued for 2011–2012

The Act continues the 2009 income tax rates through 2012, including the preferential 15% tax rate for long-term capital gains and qualified dividends. Apart from other changes discussed later in this Bulletin, these changes include:

- Withholding of Social Security tax from wages and self-employment income for 2011 decreased by two percentage points (with the gap made up from general federal revenues)
- AMT “relief” for most taxpayers through 2011
- Ability to deduct state sales tax as an itemized deduction through 2011
- Enhanced business capital investment deductions and research and development credits

Summary of Changes to Transfer Tax Rates and Exemptions

Tax:	2009		2010			2011–2012		2013 (if no action)		
	Exemption	Rate	Exemption		Rate	Exemption	Rate	Exemption		Top Rate
Gift	\$1,000,000	45%	\$1,000,000		35%	\$5,000,000	35%	\$1,000,000		55%
Estate	\$3,500,000	45%	\$5,000,000	[1]	35%	\$5,000,000	35%	\$1,000,000		55%
GST	\$3,500,000	45%	\$5,000,000		0%	\$5,000,000	35%	\$1,400,000	[2]	55%

Notes: [1] Executors for decedants dying in 2010 may opt out of estate tax, into carryover basis.

[2] The GST exemption shown for 2013 is a projection, as it would be \$1,000,000 indexed for inflation.

Estate Tax Made Optional for 2010

Under the 2001 tax act, the estate tax had been gradually eased, and was then repealed for one year only, 2010. The new Act reinstates the estate tax and stepped-up basis (used for measuring capital gains) effective January 1, 2010. This default rule benefits most estates that are too small for estate taxes but benefit from having stepped-up basis automatically apply to all assets. However, the executor of a 2010 estate may elect to opt out of the estate tax and instead apply carryover basis (where the heirs take the decedent’s basis). (See the item below regarding due dates.)

Transfer Tax Exemptions Increased, Tax Rates Reduced

The Act resets the estate tax exemption to \$5,000,000 per decedent, effective January 1, 2010 (up from \$3,500,000 in 2009). The exemption for the GST tax is also \$5,000,000 effective January 1, 2010. The Act also increases the gift tax exemption to \$5,000,000 to re-unify it with the estate tax exemption, but that change is delayed until 2011. These exemption amounts are also adjusted for inflation, beginning in 2012. However, all of these exemptions will revert to \$1,000,000 in 2013 unless Congress takes additional action. The Act sets a **35% tax rate** on estates, gifts, and generation-skipping transfers above the exemption amounts. This compares favorably with the 45% top rate that applied in 2009, and the 55% rate that would have applied in 2011 if Congress had not acted (and will apply in 2013 if Congress fails to take additional action).

The Act also changes how prior taxable gifts are taken into account in gift and estate tax calculations, by applying the tax rates for the year in question rather than the year of the prior gifts. In our October 2010 Bulletin, we described how the transition in the gift tax rates and exemption from 2010 to 2011 would allow some donors who had already used all of their gift tax exemption to make a modest additional tax-free gift of \$36,585 in 2011. The Act's changes in the gift tax rate, exemptions, and calculations of taxes on prior taxable gifts will eliminate that effect for 2011, but will allow much more extensive tax-free gifts.

Due Dates for 2010 Returns, Disclaimers

To prevent unfairness, the Act extends the due date for all estate and GST tax returns affected by the Act until September 17, 2011, nine months after the date of enactment (as that date falls on a Saturday, the effective date will be September 19, 2011). The due date for related tax payments is also extended to the same date. The deadline for qualified disclaimers (an affirmative election to decline a gift or bequest, treated under federal law as if the disclaimant had predeceased the transfer) is also extended to September 17, 2011. However, the due date for 2010 gift tax returns was **not** extended.

Generation-Skipping Transfer Tax Rate Fixed at Zero for 2010

The Act sets the GST tax rate at **zero** for all of 2010 (including the balance of the year after enactment). This means that gifts, bequests, trust terminations, and trust distributions to grandchildren made this year will face no GST tax. If the transfer was made to a trust for a grandchild, the GST tax consequences are more tricky. Neither the transfer to the trust nor a future distribution to the grandchild will be subject to GST tax. However, future distributions from the trust to great-grandchildren or younger descendants will be subject to GST tax unless the trust is made exempt by allocation of the transferor's GST exemption. In addition, a transfer in 2010 to a typical generation-skipping trust that benefits children, grandchildren, and younger descendants will not be exempt from GST tax in the future unless the trust is made exempt by allocation of the transferor's GST exemption. If you have already made or plan to make gifts to grandchildren in 2010, contact a member of our Estate Planning Group to discuss the effects of the new Act, including reporting requirements and tax elections.

Unused Estate Tax Exemption Transferable to Surviving Spouse

Beginning in 2011, the unused estate tax exemption of the first spouse to die may be transferred to the surviving spouse by an election filed with the first spouse's estate tax return. This may require the filing of an estate tax return in cases where a return would not otherwise be required. The surviving spouse may use this transferred exemption for lifetime gifts as well as for bequests at death. Only the unused exemption from the last deceased spouse will apply, and the death of a subsequent spouse will reset the identity of the last deceased spouse. However, lifetime gifts could use a predeceased spouse's exemption before the death of a subsequent spouse changes the amount of exemption available.

For planning purposes, transferability of the unused estate tax exemption of the first spouse does not eliminate the value of so-called credit shelter trusts and QTIP trusts as part of the estate plan. As one example, the new law does not allow the unused GST tax exemption of the first spouse to be transferred to the surviving spouse. The credit shelter trust and QTIP trust are two tools to avoid wasting the first spouse's GST tax exemption.

Bullets Dodged

The Tax Reform Act of 2010, in its final form, did not include recent legislative proposals (some of which had already passed in the House or Senate, but not both) to reduce or eliminate the effectiveness of several of the most attractive estate planning techniques. The final legislation did not include recent proposed legislation to reduce or eliminate valuation discounts on intra-family transfers of non-operating partnerships and LLCs, to impose a 10-year minimum term on grantor retained annuity trusts (commonly known as GRATs), or to require taxpayers to use a consistent basis for estate and income tax purposes.

Direct Gifts from IRAs to Charities Reinstated for 2010–2011

In 2008–2009, IRA owners over age 70½ could make direct distributions from their IRAs to charities of up to \$100,000 per year and exclude the amount from income, while treating it as part of their required minimum distribution. The new law extends that option through 2011. Because so little time remains in 2010, a special rule permits taxpayers to make such a transfer in January 2011 and treat it as if it had been made on December 31, 2010.

Roth Conversions

The new Act did not change the rules regarding Roth IRA conversions, discussed in prior Bulletins. The only thing that expired in 2010 was the election to report the tax over the following two taxable years (2011 and 2012). Conversions in 2011 will still work as in 2010, except that the taxable income has to be recognized entirely in 2011.

The New Law's Effect on Estate Planning

The fundamental principles and priorities of estate planning will remain the same. However, the effect and relative value of certain specific techniques have changed. Some opportunities have been improved, others have disappeared, and still others remain but have decreased in relative importance.

As noted at the opening of this Bulletin, the new tax laws create extraordinary estate planning opportunities for high-net-worth individuals. Additionally, the new tax laws will impact the basic estate plan of nearly all persons with significant assets. Estate planning for married persons with combined estates of less than \$10,000,000 will be particularly complex, given the possibility that the estate, gift, and GST tax exemptions will revert to only \$1,000,000 per person in 2013.

Time for Action

A few of the opportunities described in this Bulletin have an absolute expiration date: December 31, 2010. Others may expire as soon as December 31, 2012. Your advisors in the Estate Planning Group at Vedder Price P.C. can identify the opportunities that are most relevant in your situation and help you implement strategies to take advantage of those opportunities while they remain available. Contacting us soon will help us identify the actual and practical deadlines involved.

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For questions about estate planning opportunities created by the current economic environment, please contact any member of the estate planning group.

About Vedder Price

Vedder Price P.C. is a national business-oriented law firm composed of 265 attorneys in Chicago, New York City and Washington, D.C.

The Estate Planning Group

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If you have any questions regarding material in this issue of the Estate Planning Bulletin or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor, Igor Potym (group leader), at 312-609-7542 or at ipotym@vedderprice.com.

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