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Trusts & Estates Newsletter

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Estate and Gift Tax Changes

As promised in our December, 2010 Legislative Update, we are reviewing in greater detail the estate and gift tax changes recently enacted by Congress to apprise you of what those changes may mean for your estate plan.

Overview of the New Law

As we outlined in December, the new legislation has four major components:

1. For decedents dying in 2011 and 2012, the federal estate tax exemption amount is $5 million and the federal estate tax rate is 35%. Beneficiaries who receive assets from decedents dying in 2011 and 2012 receive those assets with a basis equal to the fair market value at the decedent's date of death (often referred to as the "step up in basis"). In addition, any unused estate tax exemption of the first spouse to die may be transferred to a surviving spouse with certain restrictions (often referred to as "portability").

2. The federal gift tax exemption for taxable lifetime transfers in 2011 and 2012 is $5 million and the gift tax rate is 35%.

3. For transfers in 2011 and 2012, the generation-skipping transfer tax ("GST tax") exemption is $5 million and the GST tax rate is 35%.

4. The estates of decedents dying in 2010 are presumed to have $5 million of federal exemption, an estate tax rate of 35%, and a full step up in basis. However, executors have the option of electing to have no estate tax apply, but with the trade-off of having a limited step up in basis.

The significant question resulting from the legislation is how it affects estate planning in 2011 and beyond.

Trusts & Estates

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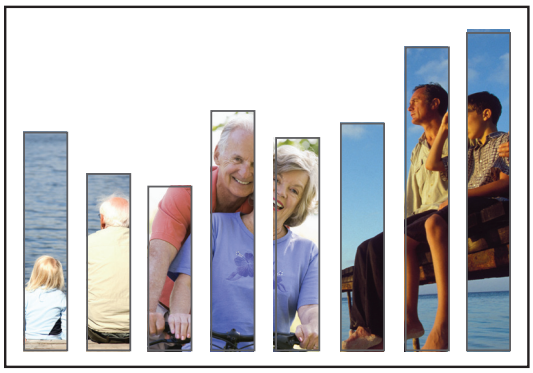
Estate Tax Changes

By way of background, for estates of individuals dying in 2009, the top estate tax rate was 45%, and there was a $3.5 million exemption. The top rate was to increase to 55% for estates of individuals dying after 2010, and the exemption was to be only $1 million. Now, for 2011 and 2012, the estate tax rate is 35%, and the exemption increases to $5 million in 2011 with a further increase for inflation in 2012. However, at least for now these changes are only temporary. After 2012, the top rate is scheduled to increase to 55%, and the exemption is scheduled to drop to $1 million.

The unique component of the new legislation is that it allows any exemption that remains unused at the death of a spouse who dies in 2011 or 2012 to be available for use by the surviving spouse in addition to his or her own $5 million exemption -- so called "portability". Interestingly, for the surviving spouse to take the first-to-die's unused exemption, an election must be made on a federal estate tax return for the first-to-die spouse's estate even if that estate is under $5 million and, therefore, would not otherwise require the filing of such a return. This requirement could be a trap for the unwary because many taxpayers may assume that they simply take the first-to-die's exemption automatically.



More broadly, portability raises the prospect of couples being able to forgo the level of estate planning that had previously been necessary to take advantage of both individuals' exemptions. Under prior law, the exemption of the first spouse to die would be lost if everything were left to the surviving spouse, and unnecessary estate tax might result at the death of the survivor. The most common way to make sure that this did not occur was to set up a trust upon the death of the first to die to hold the exemption amount. Sometimes this was done directly and sometimes by way of a "disclaimer" structure.

With portability, the question is whether couples can simply leave everything outright to each other and then to their beneficiaries upon the survivor's death and achieve the same tax result previously achieved by funding a trust at the death of the first to die. The answer is maybe, but there are a number of reasons that make such a simple plan a potentially expensive proposition.

First, Connecticut maintains a $3.5 million exemption from its estate tax and has no portability. Failure to carve out a trust to hold the Connecticut exemption amount on the first death could result in unnecessary Connecticut estate tax at the death of the surviving spouse. Second, a trust or trusts sheltering the full $5 million federal estate tax exemption amount at the first death protects appreciation occurring between the death of the first spouse and the death of the second spouse from being subject to estate tax; portability carries no inflation adjustment and thus does not achieve the same result. Third, there is no portability for the GST tax exemption and thus, for couples aiming to maximize the use of their combined GST tax exemptions, the creation of a trust or trusts on the first death is necessary. Fourth, the transferred estate tax exemption may be lost if the surviving spouse remarries. It is also important to consider that portability may very well expire on December 31, 2012. And, of course, there are often non-tax considerations that lead couples to feel more comfortable with a trust being funded on the first death.

Gift Tax Changes

Years ago, the gift tax and the estate tax were unified - they shared a single exemption and were subject to the same rates. This was not the case in recent years. For gifts made after December 31, 2010, however, the gift tax and estate tax are reunified and an overall $5 million exemption applies. This presents a potentially significant opportunity for some clients to shift assets to children and others, with no transfer tax cost. The great uncertainty is whether this $5 million unified gift and estate tax exemption will survive past 2012; extension of the increased exemption would require action on the part of Congress. If the last few years have taught us anything, it is to be cautious when predicting future legislation. Therefore, while it seems likely at this point that the $5 million exemption will be extended beyond 2012, it will be well worth monitoring the legislative environment, as grid-lock in Congress could mean that to take advantage of this tax-savings opportunity, you may have to make gifts prior to December 31, 2012.

Conclusion

Over the last few years we have resisted the temptation to encourage our clients to make changes to their existing estate plans based on the ever shifting legislative winds. The legislation in December sets up a structure and level of exemptions at the federal level that may carry forward for a number of years. At the same time, it seems unlikely that Connecticut, facing its own significant budget issues, will increase its current $3.5 million exemption to match the new $5 million federal level. This difference between the amounts of the federal and state exemptions could be problematic as many current estate planning documents contain formulas that reference only the federal exemption and therefore could cause a Connecticut estate tax to be due at the death of the first spouse. These problems can be addressed by revising the formula in most plans. Although waiting to see what happens in the Connecticut legislature over the next couple of years or what Congress does about 2013 and beyond is certainly an option, most clients should consider contacting their attorney in the Trusts & Estates practice group to review the impact of the new legislation.

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