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A report for clients and friends of the firm.

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With over a century of combined experience, the lawyers in Proskauer's Personal Planning Department regularly provide their diverse clientele, from business entrepreneurs and corporate executives to sports figures and performing artists, with their Personal Planning Strategies Newsletter, a critical source of information which identifies significant issues of interest to Proskauer's clients. The Personal Planning Strategies Newsletter provides articles addressing the latest statutory changes and developments affecting retirement, estate, insurance and tax planning, as well as cutting-edge corporate, real estate and tax concepts.

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

Summary and Planning Points

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act") has passed both Houses of Congress and President Obama will sign the Act. In addition to extending President Bush's income tax cuts, the Act addresses the Estate, Gift and Generation-Skipping Transfer ("GST") tax laws for 2010, 2011 and 2012.

We have prepared a summary of the Estate, Gift and GST tax provisions in the Act, and offered some planning points. Additionally, charts comparing the Act to prior law can be found at the end of this bulletin. Importantly, some of these suggestions should be implemented prior to the end of the year.

1. Estate Tax – 2010 Decedents Have a Choice, Exemption Is Up to $5 Million and Rate Is Down to 35%

Prior Law

Under prior law, the Federal estate tax (the "estate tax") was repealed in 2010. Therefore, for a person dying in 2010, regardless of the size of his or her estate, no estate taxes would be due. The estate tax was to be revived in 2011 but with rates and exemptions determined under 2002 law, meaning that the Federal estate tax exemption (often referred to as the "unified credit amount" or the "exemption amount") was to be $1,000,000 (which was down from the 2009 exemption amount of $3,500,000), with a top tax rate of 55% (which was up from the 2009 top tax rate of 45%). The effect of the lower exemption/higher rates was staggering – in 2009, a married couple could protect up to $7,000,000 of property from the estate tax and have any excess property taxed at 45%; in 2011, under prior law, that same couple would only be able to protect $2,000,000 of property from the estate tax with total property in excess of $2,000,000 taxed at a top estate tax rate of 55%.

In addition, when a person dies while the estate tax is in effect, the person's estate receives an income tax benefit in the form of a "cost basis adjustment." An individual who sells an asset at a gain will usually pay a tax on the gain. When an individual dies, however, any gain that may exist at the time of death is eliminated by a provision under the income tax laws that increases the cost of the assets to the person, called the person's "cost basis" in the asset, to the value at the time of the person's death. This is called a "step-up" in the cost basis, and it prevents the person's assets from being taxed both for estate tax and income tax purposes.

As stated above, under prior law there was no estate tax for 2010; this means that the "step-up" provisions also did not apply. Instead, prior law granted every decedent a total of $1,300,000 in "step-up" adjustments which the decedent's executor could allocate to appreciated assets owned by the decedent at death. Such adjustments eliminated up to $1,300,000 of gain in the decedent's assets (the "basis adjustment amount"). For married individuals, property passing to the spouse (either outright or to a marital trust) was entitled to an additional $3,000,000 of basis adjustments for appreciated assets, which could have effectively eliminated $4,300,000 of gain in the decedent's assets.

Repeal Is "Repealed"

Under the Act, the estate tax repeal is to be "repealed," so that the estate tax is once again effective for persons dying in 2010. However, the exemption amount is set at $5,000,000 and the top estate tax rate is 35%. The $5,000,000 exemption amount will be indexed for inflation after 2011.

As for the income tax issues, because the estate tax is revived, so too are the former "step-up" rules, so that if the estate is subject to the estate tax, all of the estate's assets receive a full "step-up" in cost basis to the value of such assets at the decedent's death.

Special Election To Opt Out of the Estate Tax

A special election is available for all decedents dying in 2010 whereby the decedent's executor can "opt out" of the estate tax, meaning that no estate tax would be due for 2010, and the estate would be subject to the 2010 rules as if the Act had not been implemented. For example, estates of decedents whose estates are well in excess of $5,000,000 may wish to opt out of the estate tax and forego the full cost basis "step-up" because the overall tax that would be due on the recognition of gain would be less than the estate tax that would be due on the decedent's death. Conversely, the executor of a single individual who dies with an estate of $4,000,000 and which has $2,000,000 of built-in gains (which is in excess of the available $1,300,000 adjustment amount) may decide not to make the election so that the estate would be subject to estate tax; in this instance, however, the total estate is less than the exemption amount, so no estate taxes would be due, and all assets would receive the cost basis "step-up," thereby eliminating the $2,000,000 of built-in gains.

From the examples above, it is readily apparent that the decision to opt out of the estate tax should be determined on a case-by-case basis.

Returns

As of now, it is not known how the “opt-out” election will be made; the Internal Revenue Service (the “IRS”) will eventually publish rules and forms guiding taxpayers on the election. In addition, should an estate be subject to the estate tax, estate tax returns for estates of decedents dying in 2010 will be due within 9 months after the Act is enacted (ordinarily, such returns are due 9 months after the decedent’s date of death).

Planning Points

> Generally, if the value of the estate in 2010 is $5,000,000 or less (ignoring, for this purpose, any prior taxable gifts that are generally added to the value of a decedent’s assets to compute estate tax), an executor should *not* elect out of the application of the estate tax. In this case, the $5,000,000 exemption will encompass the entire estate, resulting in no estate taxes. Additionally, the inherited assets of such an estate will receive a full “step-up” in cost basis to the value of such assets at the decedent’s death.

> If the value of the estate in 2010 is over $5,000,000, an executor *should* consider electing out of the application of the estate tax. The key to this decision is whether the benefits of the additional basis “step-up” are outweighed by the estate tax that would otherwise be due, *i.e.*, which is less – the ultimate capital gains tax on the non-”stepped-up” assets or the estate taxes. If you are the executor of the estate of a decedent who died in 2010 with a value over $5,000,000, we can conduct an analysis to determine whether you should “opt out” of the estate tax.

> Married couples with assets in excess of $10,000,000 should divide their assets so that each has at least $5,000,000. It should be noted that some assets, such as IRAs, are not divisible; in such cases, special planning needs be considered.

2. Gift Tax - Exemption Is “Reunified” with the Estate Tax Exemption and Increases to $5,000,000

Prior Law

Under prior law, each individual had a lifetime exemption from the Federal gift tax (the “gift tax”) of $1,000,000. This meant that an individual could make gifts of up to $1,000,000, in the aggregate, during his or her life before having to pay any gift tax. In addition, an individual may gift up to $13,000 per year to any other person ($26,000 in the case of a married couple) free from any gift tax. This is known as the “gift tax annual exclusion.” Finally, individuals may make unlimited transfers for medical expenses and tuition for education without any gift tax consequences if the transfers are made directly to the health care provider and educational institutions, respectively.

Increased Exemption Amount

Under the Act, the main change with respect to the gift tax is that as of 2011, the gift tax lifetime exemption amount is “unified” with the estate tax exemption, meaning that the amount of the gift tax exemption increases from $1,000,000 to $5,000,000. Some clients may recall that, many years ago, the gift and estate tax exemptions were unified, which is why this portion of the Act is known as "Reunification." As of 2011, an individual may make total gifts, excluding annual exclusion gifts or transfers for medical or educational purposes (such total gifts are called "taxable gifts"), of up to $5,000,000, in the aggregate, during his or her life before owing any gift taxes. This $5,000,000 gift tax exemption is adjusted for inflation after 2011. As a caveat, it should be noted that the $5,000,000 gift tax exemption is reduced by any gift exemption used prior to 2011, so that if an individual utilized $750,000, for example, of his/her gift tax exemption prior to 2011, the available gift tax exemption in 2011 is only $4,250,000.

Planning Points

> As of January 1, 2011, individuals who have already fully utilized their $1,000,000 Federal lifetime gift tax exemption will have another $4,000,000 of gift tax exemption available to them. Thus, any asset transfer techniques that the individual may not have considered because it would have resulted in the payment of gift tax may now be reconsidered.

> The Act creates opportunities to shift income to taxpayers (*i.e.*, children) who may be in lower income tax brackets.

3. Generation-Skipping Transfer Tax – Tax Revived in 2010 But Rate Is 0%!

Basics

The GST tax is perhaps the least known and most misunderstood of the Federal transfer taxes. Generally speaking, the GST tax applies to a transfer (whether by gift or bequest) from an individual to his/her grandchild, thus "skipping" the child. The IRS would prefer that there be an estate or gift tax upon the passing of property between each generation; however, because a GST "skips" a generation, there is no transfer tax at the skipped level. Therefore, the GST tax was enacted to force a tax at the skipped generation. Traditionally, the GST tax is assessed at the highest applicable estate tax rate.

Prior Law

Under prior law, the GST tax, like the estate tax, was not applicable for property transfers in 2010. In 2011, the GST tax was to be revived and, like the estate and gift tax exemption amounts, individuals were given a GST exemption amount equal to $1,000,000 (as indexed for inflation since 2001, or approximately $1,300,000). Excluding the applicability of the estate and/or gift taxes, this meant that in 2010 a grandparent could transfer (by gift or bequest) as much property as he or she desires directly to a grandchild without having to pay GST tax at the time of the transfer, whereas in 2011 a grandparent could transfer (by gift or bequest) only up to $1,000,000 (as indexed for inflation since 2001, or approximately $1,300,000) without paying GST tax.

2010 – Revived, But at 0%

Under the Act, the GST tax is revived for 2010; however, the GST tax rate is 0%. Thus, if a grandparent makes a transfer (by gift or bequest) to a grandchild in 2010, that gift or bequest would be subject to the GST tax because it effectively "skips" the children's generation; however, no tax is due on the transfer because the GST tax rate is 0%. Although under the Act an analysis of the GST tax consequences of a transfer to a grandchild is completely different than such an analysis under the prior law (which, for technical reasons, are beyond the scope of this bulletin), the result is the same – the transfer does not result in any GST taxes being paid in 2010.

Increased Exemption Amount

Under the Act, for 2010 and beyond, the GST exemption amount is increased to $5,000,000, and is indexed for inflation after 2011.

Planning Points

> In 2010, individuals should consider making outright gifts to grandchildren, which, although subject to gift tax, will not create any GST taxes owed because the 2010 GST tax rate is zero.

> In 2010, trustees of "non-exempt GST trusts" should consider making distributions to grandchildren or more remote descendants – because such distributions will not be subject to GST tax.

> Gifts in Trust Only for Grandchildren:

In 2010, if an individual gifts property to a trust that is solely for the benefit of grandchildren, such gift will be subject to both the gift and GST taxes, but, because the GST tax rate in 2010 is 0%, there will be no GST taxes imposed on the transfer. The key to this plan, and the reason why gifts to grandchildren should be made before the end of 2010, is that GST taxes are effectively imposed in 2010 (albeit at a tax rate of 0%). Consequently, because such taxes are imposed, future distributions from the trust to grandchildren should not be subject to the GST tax. Rather, the GST tax is postponed until the grandchild's death. For this reason, strong consideration should be given to such gifting before the end of 2010. If this technique is implemented, it is critical that an election is made on a gift tax return to "opt out" of the automatic allocation of GST exemption that would otherwise apply.

> Gifts in Trust for Children and Grandchildren:

If an individual transfers property to a trust in 2010 for the benefit of both children and grandchildren, because a child has an interest in the trust, the gift will be subject to the gift tax but *not* the GST tax (in 2010 a desired result is to have the trust subject to GST tax since the tax rate is 0%). Unless GST exemption is allocated to the transfer, distributions from the trust to grandchildren in 2011 and beyond will be subject to the GST tax. Because this transfer is not a GST, the transferor cannot take advantage of the 0% 2010 GST tax rate, which would prevent future distributions from the trust from being subject to GST tax. Therefore, clients may wish to defer implementing this strategy until 2011 when the client has an increased gift tax exemption to utilize in order to reduce the gift tax impact of the transfer.

4. Portability – Surviving Spouses Can Utilize Deceased Spouse's Unused Exemption Amount

Prior Law

Under prior law, if an individual dies failing to utilize all of his/her gift and estate tax exemption, this exemption is forever lost.

“Portability” – Utilizing the Spouse’s Unused Exemption Amount

Under the Act, beginning in 2011, a surviving spouse would be able to utilize the unused exemption of his/her “deceased spouse” if the deceased spouse died after 2010 (*i.e.*, $5,000,000 if no exemption was used during life). This means that, with respect to a typical husband and wife, if, in 2011, the husband dies and does not fully use his estate tax exemption, the unused exemption is then attributed to the wife, so that when she dies, her estate plan can use both her estate tax exemption and her late husband’s unused exemption. For example, suppose a wife dies in 2011, is survived by her husband, and she only utilizes $2,000,000 of her $5,000,000 estate tax exemption. Upon the husband’s subsequent death, his estate has an estate tax exemption comprised of his own $5,000,000 exemption as well as the deceased wife’s $3,000,000 of unused exemption, for a total estate tax exemption of $8,000,000. This is referred to as “portability.”

Portability must be affirmatively elected, meaning that the deceased spouse’s executor will be required to indicate the election on the deceased spouse’s estate tax return, signifying that the surviving spouse may utilize the deceased spouse’s unused estate tax exemption. This means that the deceased spouse’s estate will need to file an estate tax return regardless of the value of the estate.

We again stress that the portability of a deceased spouse’s unused estate tax exemption applies only to estates of decedents dying after December 31, 2010. This means that if an individual dies in 2010, regardless of whether his or her executor elects to have the estate tax apply, the decedent’s estate tax exemption is not portable to the surviving spouse.

Further, this benefit is limited to the unused estate tax exemption of the “last” deceased spouse of the surviving spouse. This rule is intended to avoid “serial marriages” to accumulate unused exemption. For example, assume Spouse 1 dies in January 2011 using only $2,000,000 of his $5,000,000 estate tax exemption, and his executor elects to allow the surviving spouse to use the unused portion of Spouse 1’s estate tax exemption (*i.e.*, $3,000,000). Further assume that the surviving spouse subsequently marries Spouse 2, and Spouse 2 dies in March 2011 using only $1,000,000 of his $5,000,000 estate tax exemption. Spouse 2’s executor elects to allow the surviving spouse to use the unused portion of Spouse 2’s estate tax exemption (i.e., $4,000,000). If the surviving spouse subsequently dies in December 2011, the surviving spouse’s estate tax exemption is $9,000,000 (*i.e.*, the surviving spouse’s own $5,000,000 estate tax exemption plus Spouse 2’s $4,000,000 of unused estate tax exemption) and not $12,000,000 (*i.e.*, not the surviving spouse’s own $5,000,000 estate tax exemption plus Spouse 1’s $3,000,000 of unused estate tax exemption plus Spouse 2’s $4,000,000 of unused estate tax exemption).

Not Applicable to GST Exemption

It is important to stress that portability only applies to the “unified” estate and gift tax exemption amount – it does *not* apply to any unused GST exemption.

Planning Points

Even with portability, married couples should continue to structure their estate plans so that both spouses fully utilize their exemptions at the time of their respective deaths. For example, by using a "bypass trust" and properly dividing their assets, both spouses can utilize their estate tax exemptions without the need for portability. A "bypass trust" is drafted in a manner that allows assets to "bypass" the estate tax that otherwise would be imposed when the second spouse dies. Aside from the non-tax benefits (e.g., creditor protection) of holding assets in trust, funding a "bypass" trust on the first spouse's death allows any appreciation in value of the trust assets that occurs between the first death and the second death to avoid estate tax. Relying solely on the portability rule will not allow such increase between deaths to avoid estate tax.

For example, assume that a husband dies in 2011 and his entire estate - $3,000,000 - is placed in a "bypass" trust for the benefit of his wife. This results in the husband having an unused estate tax exemption of $2,000,000. Assume further that upon the wife's subsequent death in 2011, the assets in such trust have appreciated in value to $5,000,000 and the wife's individual assets (exclusive of the trust) total $7,000,000. The $5,000,000 in trust would not be subject to estate tax on the wife's death because it is held in a "bypass" trust. Further, no estate tax would be due on the wife's death because the wife's estate tax exemption is equal to $7,000,000 (i.e., $5,000,000 of her own estate tax exemption and $2,000,000 of the husband's unused estate tax exemption).

Conversely, assume the same facts except that the husband's $3,000,000 is left outright to the surviving spouse. On the husband's death, no estate tax would be due because all of the property is left outright to his wife and therefore qualifies for the estate tax marital deduction. Further, because no estate tax exemption is needed to eliminate estate tax upon the husband's death, the husband's executor elects to allow the wife to use the husband's full $5,000,000 of unused estate tax exemption. By the time of the wife's death, the $3,000,000 from the husband's estate appreciates to $5,000,000, meaning that the wife's estate totals $12,000,000 ($3,000,000 from the husband, $2,000,000 in appreciation and $7,000,000 of her own assets). The wife's total assets exceed the total of her available estate tax exemption by $2,000,000 ($12,000,000 in assets less $10,000,000 available estate tax exemption), thus causing her estate to owe estate taxes.

Finally, although portability would seemingly prevent the waste of an individual's estate tax exemption, we continue to recommend that married couples divide their assets equally between them because, as mentioned previously, the use of a "bypass" trust can shield future appreciation in assets and the GST tax exemption is not portable. Additionally, relying on the application of the portability rule is risky because it is dependent upon the executor of the deceased spouse's estate making an election to pass on the unused exemption to the surviving spouse.

5. GRATs – Safe for the Near Term

One topic that is not included in the Act but should be referenced is the use of grantor retained annuity trusts, or "GRATs."

Introduction

A GRAT is a technique whereby an individual transfers property into a trust for a short period of time, say, two years, and receives the property back over the two year period in the form of an annuity. The annuity is determined, in part, based on an interest rate established by the IRS (the "Valuation Rate"). At the end of the trust term, if the assets have appreciated in value, the appreciation passes to the trust's remainder beneficiaries with minimal or no current gift tax liability. This is referred to as "zeroing out" the GRAT because the value of the remainder interest in the GRAT for gift tax purposes is very close to zero. If the GRAT's assets appreciate and/or produce income at a rate higher than the Valuation Rate, it is likely that the GRAT will be successful because property will pass to the remaindermen with little gift tax consequences. If the individual dies during the term, the entire value of the GRAT is included in the individual's estate for estate tax purposes, which is the same result as if the individual had done nothing. For this reason, we often have referred to the GRAT technique as "heads you win, tails you tie." The key to the success of most GRATs thus lies in the ability to "zero-out" a GRAT with as short an annuity term as possible and as low a Valuation Rate as possible.

2010 Attempts To Increase the Annuity Term

Earlier this year, President Obama included in his budget proposals new legislation that would require a 10-year minimum term for a GRAT (the "10-year term"). While GRATs would still be a viable planning tool, the 10-year term would reduce a great deal of the GRAT's effectiveness because the individual would then have to outlive the 10-year term; also, the long-term fluctuation in asset value could diminish any appreciation that may be earned in the short term. Throughout the past year, various bills were presented in both houses of Congress that would have mandated a 10-year term.

The Act Is Silent – GRATs Live To Fight Another Day

The Act does not include any references to GRATs, meaning that short term GRATs appear to remain viable for the near future.

Planning Points

With respect to GRATs, optimal results are achieved through (a) the shortest annuity term possible, and (b) the lowest Valuation Rate possible. As stated above, the Valuation Rate establishes the benchmark for determining the annuity amount payable to the creator of the GRAT. Thus, the lower the Valuation Rate, the lower the threshold for the GRAT's assets to appreciate/produce income in excess of the Valuation Rate. The reason that this is pertinent is that interest rates are currently at historical lows, and the Valuation Rate for December 2010 is at an all-time low of 1.8%. Thus, this is the perfect time in which to create a GRAT.

6. Final Thoughts

We are available to assist with any questions you may have. The planning points outlined above do not apply to every client, and a tax advisor should be consulted prior to implementation. We strongly recommend that clients revisit their current estate planning documents, particularly as higher exemptions may substantially impact the disposition of assets under current documents in which formula provisions are used.

7. Chart Summary

Under the prior law:

	2009	2010	2011
Estate Tax Exemption	$3.5 million	None, because no estate tax	$1 million
Maximum Estate Tax Rate	45%	No estate tax	55%
Basis Adjustment at Death	For all assets owned at death	Limited to $1.3 million, plus $3 million for property passing to a surviving spouse	For all assets owned at death
GST Tax Exemption	$3.5 million	None, because no GST tax	$1 million (indexed for inflation)
Maximum GST Tax Rate	45%	No GST tax	55%
Lifetime Gift Tax Exemption	$1 million	$1 million	$1 million
Maximum Gift Tax Rate	45%	35%	55%

Under the new Act:

	2009	2010	2011	2012
Estate Tax Exemption	$3.5 million	Election between $5 million or no estate tax	$5 million (with portability)	$5 million, indexed (with portability)
Maximum Estate Tax Rate	45%	35%	35%	35%
Basis Adjustment at Death	For all assets owned at death	Election between unlimited or $1.3 million general plus $3 million spousal	For all assets owned at death	For all assets owned at death
GST Tax Exemption	$3.5 million	$5 million	$5 million (without portability)	$5 million, indexed (without portability)
Maximum GST Tax Rate	45%	35%	35%	35%
Lifetime Gift Tax Exemption	$1 million	$1 million	$5 million (with portability)	$5 million, indexed (with portability)
Maximum Gift Tax Rate	45%	35%	35%	35%

The Personal Planning Department at Proskauer is one of the largest private wealth management teams in the country and works with high net-worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

If you have any questions regarding the matters discussed in this newsletter, please contact any of the lawyers listed below:

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