Proskauer

H.R. 4853: Summary and Planning Points

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Late last Thursday night, the Senate Finance Committee released H.R. 4853, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “Bill”). In addition to extending President Bush’s income tax cuts, the Bill addresses the estate, gift and generation-skipping transfer (GST) tax laws for 2010, 2011 and 2012.

Most politicians and Washington insiders believe that the Bill will pass the Senate. Its fate in the House of Representatives is less clear, as it is possible that the Bill may not be proposed by the House before the expiration of the current session. In such case, it is likely (at least according to those who make predictions on these types of laws) that when Congress convenes in January, the Bill, or some form of the Bill, will pass and President Obama will sign it into law.

We have prepared a summary of the estate, gift and GST tax provisions in the proposed Bill, and provided planning points that clients should consider in the event that the Bill becomes law. Note that some of these suggestions would need to be implemented prior to the end of the year if the Bill passes this year.

1. Estate Tax or No Estate Tax in 2010?

   For decedents dying in 2010, the estate tax applies. There is a $5 million estate tax exemption and a 35% top rate. The estate tax exemption will be indexed for inflation after 2011 (with rounding to the nearest $10,000). A full basis step-up applies. Estate tax returns for estates of decedents dying in 2010 will be due within 9 months after the Bill is enacted.

   Important exception: executors of estates of decedents dying in 2010 can elect out of the estate tax regime so that no estate tax is due. If such an election is made, the basis step-up rule will be limited to $1.3 million for non-spousal beneficiaries and $3 million for spousal beneficiaries. The IRS will publish rules on when and how the election is to be made.

Planning Points:

If the value of the decedent’s estate is $5 million or less (including gifts made during life in excess of annual exclusion gifts), an executor should not elect out of the application of the estate tax. No tax will be due, and a full basis step-up will be permitted.

If the value of the decedent’s estate is over $5 million, the executor should opt out if the benefits of the additional basis step-up are outweighed by the estate tax that would otherwise be due. A qualified tax professional can conduct such an analysis to determine whether the election should be made.

2. Reunification - Gift Tax Exemption is $5 Million

For gifts made after 2010 and before 2013, the gift tax exemption is $5 million – the same as the estate tax exemption. Any exemption used prior to 2010 “eats into” the $5 million exemption available under the new law. The exemption is adjusted for inflation after 2011 (with rounding to the nearest $10,000).

Planning Points:

Clients should consider postponing until January 1, 2011 year-end taxable gifts (above annual exclusion gifts) that would cause gift tax. Gifts next year would be sheltered from tax to the extent of the increased gift tax exemption. Also, by waiting until 2011, the risk of dying (and being able to pass those assets without any transfer tax) is eliminated, and the due date to pay the gift tax (if gifts exceed the new gift tax exemption) is postponed until April 15, 2012.

3. GST Tax Exemption is Increased to $5 Million for 2010 and Automatic Allocation Rules Apply

The amount of GST tax imposed on generation-skipping transfers in 2010 is zero under the proposed law. However, this does not mean that the "inclusion ratio" of gifts to trusts made in 2010 is zero, meaning that there would not be any GST tax imposed when a distribution is made in a year after 2010. Rather, there is a $5 million GST exemption for 2010 and the automatic allocation rules apply – though, as under the law prior to 2010, the taxpayer can opt out of the application of the automatic allocation rules. The GST tax exemption is indexed for inflation after 2011 (with rounding to the nearest $10,000).

Planning Points:

Clients should make outright gifts to grandchildren in 2010, as such gifts will not be subject to GST tax.

If a client makes a gift to a trust for grandchildren in 2010 (as opposed to an outright gift), there will be no immediate imposition of GST tax. With respect to whether distributions in a later year from these trusts to grandchildren will be subject to the GST tax at that time, the way the law is currently proposed, the result should be as follows:

- The proper (and preferred) answer seems to be that because of a rule in the Internal Revenue Code known as the "move down" rule, once the gift is made the new "transferor" of that trust is deemed to be the grandchild's parent. Thus, the grandchild is not a "skip person" – so that distributions from the trust to the grandchild should not cause GST to be imposed. This seems to be the correct interpretation but there is no guidance on this issue.
- When the grandchild dies, and assets pass to great-grandchildren, that will be a transfer to a "skip person" and GST tax will be imposed at that time. This result can be mitigated if the assets of the trust are included in the grandchild's estate for estate tax purposes. *Note:* this seems to be a fair result – it allows gifts to adult and minor grandchildren to be treated in the same fashion.
- In order to achieve this result, however, it is critical the donor elects out of the automatic allocation rules. Otherwise, the donor's GST tax exemption will be automatically allocated to the gift. By electing out of the automatic allocation rules, GST tax exemption is preserved for gifts after 2010 when this special situation will not apply.

Direct skip bequests at death to trusts for grandchildren should be treated the same way – even if the executor opts out of the application of the estate tax. There are some commentators who believed that if there was no estate tax, there was no transferor, and as a result there would never be GST tax imposed on distributions from that trust. The proposed Bill states that the identity of the transferor will not change regardless of whether an executor elects estate tax or carryover basis.

Although we recommended above that gifts be postponed until 2011, that recommendation does not extend to gifts to grandchildren (or to trusts for their benefit). The ability to avoid GST tax for gifts made outright in 2010 remains an important opportunity, and we recommend that such gifts be completed before the end of 2010 to the extent possible.

4. The Bill Says Nothing About GRATs

In prior proposals, the term ofGRATs would have had a minimum 10-year term. No such provision is included in the proposed legislation.

Planning Points:

Short term GRATs look like they will survive into at least the immediate future. Therefore, the “rush” to create GRATs prior to 2011 has eased. However, now is still the time to create a GRAT because the 1.8% rate used for a GRAT this month is the lowest of all time.

5. Portability of Estate Tax Exemption is Allowed

If a decedent who died in 2010 leaves a surviving spouse who dies thereafter, to the extent the first spouse to die failed to use his or her estate tax exemption, the surviving spouse can use the unused portion. The surviving spouse’s executor has to make an election to accomplish this result.

Only the unused estate tax exemption of the “last” deceased spouse of the surviving spouse can be used. This rule is intended to avoid “serial marriages” to accumulate unused credits.

Planning Points:

Creating credit shelter trusts on the first death still makes sense. Aside from the non-tax benefits (e.g., creditor protection) of holding assets in trust, funding a credit shelter trust on the first spouse's death allows any increased value of the trust assets that occurs between the first death and the second death to avoid estate tax. Using the portability rule will not allow that increase between deaths to avoid estate tax. In addition, in most cases, both spouses want to use their GST tax exemptions ($5 million per spouse, and indexed for inflation beginning in 2012). Unfortunately, the GST tax exemption is not portable. Thus, in order for the estate of the first deceased spouse to use the GST tax exemption, a credit shelter trust should be used.

Note, however, that when a spouse dies first without sufficient assets to use his or her entire estate tax exemption, portability would be of great benefit. This would eliminate the need to create lifetime QTIPs for the "poor" spouse, or the need to give assets to the "poor" spouse to allow him or her to use the estate tax exemption at the first death, assuming that the executor of the estate of first spouse to die elects to pass on unused exemption. However, the need to "equalize" estates between a "rich" spouse and a "poor" spouse will still persist with regard to GST tax planning because the GST tax exemption is not portable.

6. No Limits on Discounts

Valuation discounts are used with various estate planning techniques (i.e., family limited partnerships) to reduce estate and gift tax exposure. It had been rumored that the new tax bill would include limits on the ability to discount the value of assets in estate planning transactions. The proposed bill does not include such limits.

Planning Points:

Valuation discount planning continues to be an effective way to reduce estate and gift taxes.

7. Final Thoughts

As indicated above, the bill has not passed yet, but it is likely that it will in this or similar form. 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. Should the Bill pass, 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.

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