

Warshaw Burstein Cohen Schlesinger & Kuh, LLP

MEMORANDUM

To: Our Clients and Friends

Date: January 14, 2011

RE: Estate and Gift Tax Aspects of 2010 Tax Act

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"). The Act significantly changes the taxation of estates and gifts and presents significant estate planning opportunities.

SUMMARY OF KEY ESTATE AND GIFT TAX PROVISIONS OF THE ACT

Estate Tax

Before the Act, the federal estate tax had been gradually reduced over several years and then eliminated for persons dying in 2010.

The Act reinstates the estate tax, but with a significantly higher applicable exclusion amount (the amount exempt from federal estate tax) of \$5 million, and a lower maximum tax rate of 35 percent, than under prior law. However, this new regime is temporary and, unless extended, will expire on December 31, 2012.

For persons dying after 2010, the Act reinstates the stepped-up basis rules that had applied before 2010. In general, property owned by a decedent will receive a basis for income tax purposes equal to the property's fair market value on the date of decedent's death.

The Act gives estates of decedents who died during 2010 the option to elect either (1) to pay a federal estate tax at a maximum rate of 35 percent on assets exceeding \$5 million, with a stepped-up basis on all assets, or (2) no federal estate tax but a limitation on the amount of the basis step-up.

Gift Tax

For gifts made in 2010, the maximum gift tax rate is 35 percent and the applicable lifetime exclusion amount is \$1 million. For gifts made in 2011 and 2012, the maximum gift tax rate will also be 35 percent, but the lifetime exclusion is increased to \$5 million. As

discussed below, this change provides an opportunity to transfer significant amounts of wealth free of estate and gift taxes.

In addition to the lifetime exclusion, donors continue to be able to use the annual gift tax exclusion before having to use any part of their lifetime applicable exclusion amount. For 2010 and 2011, the annual exclusion amount is \$13,000 per donee (married couples may continue to "split" their gift and may make combined gifts of \$26,000 to each donee).

Generation Skipping Transfer ("GST") Tax

Generally, the GST tax is imposed on gifts and bequests to grandchildren and more remote descendants. The Act increases the GST exclusion amount to \$5 million (or \$10 million for a married couple) for transfers occurring in or after 2010, with a GST tax rate of zero percent for transfers occurring in 2010 and 35 percent for transfers occurring in 2011 and 2012.

OBSERVATIONS REGARDING THE ACT

Gifting Opportunities

The increase in the gift tax exclusion to \$5 million (or \$10 million for a married couple) provides an unprecedented opportunity to move substantial wealth out of taxable estates. A number of techniques, including some involving valuation discounts, can be used to leverage this \$5 million exclusion.

For example, individuals can make gifts of \$5 million to so-called grantor trusts for the benefit of their children, thereby removing from their estate all future growth and income from the donated assets (which will pass to their children), while continuing to pay income tax on the income from the donated assets (thereby effectively transferring additional wealth to their children). Grantor Retained Annuity Trusts ("GRATs") allow individuals to transfer future growth of their assets to younger generations at little or no estate or gift tax cost.

A technique referred to as an installment sale to a grantor trust enables individuals to make an initial gift of as much as \$5 million (or \$10 million for a married couple) to a trust, and then transfer as much as \$45 million (or \$90 million for a married couple) to the trust in exchange for an installment note, without the latter transfer being taxed as a gift or as a sale. This technique works especially well for interests in family businesses or other assets that are expected to increase significantly in value.

Without further Congressional action the Act will expire on December 31, 2012. Thus, it may be prudent to implement estate planning techniques utilizing lifetime gifts before the December 31, 2012 expiration date.

Effect of Act on Formula Bequests

Many wills contain "formula" bequests in which the amount of a disposition is determined by reference to the applicable exclusion amount. A common will provision creates a trust, known as a credit shelter trust, funded with the largest amount that can pass free of federal estate tax by reason of the applicable exclusion. Such a clause would have resulted in a disposition of \$3.5 million in 2009. Under the Act, the amount is now increased to \$5 million. This could mean that the amount passing to a trust for a surviving spouse, or to children and/or other beneficiaries, will be greater than planned. For this reason, existing wills should be reviewed in light of current law to avoid undesired consequences.

State Estate Taxes

Many states have separate ("decoupled") estate tax regimes with lower applicable exclusion amounts than the federal applicable exclusion amount. These include Connecticut, New Jersey, and New York, among others.

In New York State, where the state estate tax exclusion is \$1 million, the amount of the New York estate tax payable on a taxable estate of \$5 million is \$391,600. Thus, planning to minimize the state estate tax continues to be important, even in the case of estates that are not large enough to be subject to federal estate tax.

Portability and Credit Shelter Provisions

The new "portability" provisions of the Act provide in general terms that if one spouse does not fully utilize his/her entire \$5 million applicable exclusion amount (either for gift tax or estate tax purposes), the unused portion can be used by the surviving spouse or by the spouse's estate. This provision is intended to reduce the need for credit shelter trusts for the benefit of the surviving spouse for federal tax purposes.

However, credit shelter trusts may continue to provide significant tax and other benefits, given that the portability provisions are presently scheduled to expire at the end of 2012, and also for the following reasons:

- Assets in a credit shelter trust will (on the death of the surviving spouse) ordinarily pass to children and not to a new spouse, or to creditors of the surviving spouse, or to other unintended beneficiaries.
- Appreciation in assets held in a credit shelter trust is not subject to estate tax at the death of the surviving spouse, while appreciation in assets owned outright by the spouse may be subject to tax.
- Credit shelter trusts may continue to enable smaller estates in "decoupled" tax states (such as New York) to reduce state estate taxes on the death of the second spouse to die.

Changes Not Made In the Act

Two provisions that some expected to be in the Act were not included. There had been several proposals to reduce the utility of GRATs and to limit valuation discounts through the use of certain estate planning techniques, such as family limited partnerships. Since these were not included in the Act, these techniques continue, for the time being, to be available.

Temporary Relief Does Not Extend to Non-U.S. Citizens Who Are Not Resident for Estate Tax Purposes

The Act reinstates the federal estate tax on United States-situs property of non-citizens who also are not U.S. residents. For these individuals, the \$5 million estate tax exclusion is not applicable and, in general, U.S. situs property exceeding \$60,000 in value will again be subject to U.S. estate tax. Non-resident aliens must exercise care in structuring the acquisition of U.S. assets, such as real property, in order to avoid imposition of U.S. estate taxes.

Wills Should Be Reviewed

We recommend that clients review their estate plans in light of the new tax law to ensure that their wishes are properly carried out, whether in their wills or in lifetime gifts. Clients should consider using lifetime gifts to take advantage of the current \$5 million lifetime gift tax applicable exclusion amount, which, absent further Congressional action, will expire at the end of 2012. Also, regardless of the new law, clients should review their estate plans periodically and/or whenever a significant life event occurs (e.g., birth of a child, death of a spouse, purchase of new home, etc.).

Please do not hesitate to contact us with any questions you might have or if you would like to discuss your estate plan in light of the Act.

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