



# The Wealth Counselor

A monthly newsletter for wealth planning professionals

## Planning Opportunities Under 2010 Tax Act

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In the last issue of *The Wealth Counselor*, we took a first look at the changes in the federal estate, gift and generation-skipping taxes as found in the 2010 Tax Act (formally named the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010).

The 2010 Tax Act extends to December 31, 2012, the income, estate, gift and generation-skipping tax provisions enacted during the administration of President George W. Bush

("EGTRRA"). For the two-year period beginning January 1, 2011, it reinstates the unified federal estate, gift and GST exemption, sets the exemption at \$5 million and sets the tax rate on amounts over the exemption at 35%. It also includes, for those 2 years only, a new "portability" provision that allows the executor of the first spouse to die to transfer any unused gift and estate tax exemption to the surviving spouse. It also changes the estate tax law and provides an option for estates of those who died in 2010. And it presents more uncertainty, as this tax "relief" is only for two years and has built-in uncertainties. Plus, just like under EGTRRA, if Congress does not act before the sunset date, the EGTRRA provisions and the 2010 Tax Act provisions will disappear and the tax laws will revert to how they read in 2000.

These changes, and the uncertainty that comes with them, present some unique planning opportunities and challenges for estate planning professionals. In this issue, we will examine some of them.

### Opting Out of the Estate Tax for Those Who Died in 2010

The 2010 Tax Act made a retroactive reinstatement of the estate tax, setting the exemption for 2010 at \$5,000,000 (without portability), and repealed the carryover basis provisions that were unique to 2010. However, the executor for a decedent who died in 2010 may elect to opt out of the new law and therefore have the modified basis rules

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(unlimited step-down for loss assets and a limited step-up of \$1.3 million (\$60,000 for non-resident non-citizens), plus \$3 million for assets passing to a surviving spouse) and no estate tax apply.

The executor of a 2010 decedent has until September 19, 2011, to make the election; file estate tax, GSTT and basis allocation returns; pay estate tax; and make disclaimers.

**Planning Tip:** In almost all cases for 2010 estates that are less than \$5 million (the applicable exclusion amount), the election to opt out should not be made. These estates almost always come out better with the \$5 million exemption and fair market value step-up in basis. For larger estates, an evaluation will need to be made before assuming the carryover basis would be better.

### ***Considerations for Determining Whether to Opt Out of the Estate Tax for 2010 Decedents***

- Calculating how much would be paid in estate taxes now vs. capital gain tax on the future sale of assets.
- Anticipating dates of sales of assets. If no sale is expected, there is no need to take the election.
- Considering ability to allocate basis adjustments up to the fair market value at the date of death for assets that will likely be sold in the near future.
- Anticipating future capital gains rates and ordinary income rates for ordinary income property.
- Weighing present value of anticipated income tax costs against current estate tax amount.
- Considering how to resolve potential disputes among heirs regarding the \$1.3 million limited basis increase. (The surviving spouse will always get the \$3 million step-up.)

*Example #1:* John dies in 2010, leaving \$6.3 million estate with \$5 million basis to Child.

Estate tax calculation: \$6.3 million estate minus \$5 million exemption equals \$1.3 million taxable estate. Tax rate of 35% produces \$455,000 due in estate taxes.

Income tax calculation: \$6.3 million in assets minus \$5 million basis equals \$1.3 million gain. Apply the \$1.3 Special Basis Allocation so Child's basis is now \$6.3 million, generating complete step-up in basis.

Result: Carryover basis option is the easy choice.

*Example #2:* John dies in 2010, leaving \$8 million estate with basis of \$2 million to wife Olivia.

Estate tax calculation: \$8 million estate using unlimited marital deduction equals zero taxable estate with zero estate tax. Complete step-up in basis provided under Section 1014. If left in QTIP, can make partial QTIP election to preserve \$5 million exemption amount or possible disclaimer to remainder beneficiaries. On Olivia's death (assuming no asset growth and permanency of new tax law), estate tax is 35% of \$3 million = \$1,050,000.

Income tax calculation: \$8 million in assets minus \$2 million basis equals \$6 million built-in gain. Only \$4.3 million of basis adjustment available (special basis allocation of \$1.3 million plus spousal basis adjustment of \$3 million). Capital gains tax = 15% x \$1.7 million = \$255,000.

Result: Adjusted basis of \$6.3 million vs. \$8 million basis with estate tax. Also leaves \$1.7 million subject to capital gains in the future.

**Planning Tip:** Estate taxes are payable currently. Capital gains taxes are only payable when the assets are sold. If they are not sold and the beneficiary dies with the assets in his estate, they would receive a full step-up in basis at his death (assuming current law).

### **Generation-Skipping Transfer Tax Planning**

With the extension of EGTRRA, concerns for the GSTT in 2010 have been resolved. The GSTT exemption for 2010 was \$5 million and the tax rate for 2010 only was 0%. While the sunset provision of EGTRRA still exists, the \$5 million GSTT exemption and 35% tax rate will allow for some interesting planning opportunities over the next two years.

The goal of GSTT planning is to transfer wealth to generations beyond one's children tax free. The 2010 Tax Act opens a window of opportunity that makes this easier. When the GST exemption was \$1 million, it was a very limited resource; sometimes it could be difficult to decide how to best use and leverage it over multi-generational gifting trusts, ILITs and IDGTs. With the larger GST exemption, choices are less limited and easier to implement. The \$5 million exemption makes it easy to create much larger dynasty trusts that will be exempt from estate taxes and provide asset protection for as long as the applicable Rule against Perpetuities will allow.

**Planning Tip:** Design multi-generational trusts so that gifts to the trust are completed gifts to avoid inclusion in the grantor's estate. Avoid estate tax in the beneficiaries' estates by making sure that no beneficiary has a general power of appointment. Benefit multiple generations by using cascading trusts. Allocate sufficient GSTT exemption to always have an inclusion ratio of zero.

**Planning Tip:** In the past, even if you could find enough Crummey beneficiaries to cover the annual premium for a multi-generational ILIT for gift tax purposes, allocating GSTT exemption to cover all of the premium payments was often the sticking point. A \$5 million GSTT and gift tax exemption until December 31, 2012, makes trust funding for future premiums and single pay policies attractive options.

**Planning Tip:** Clients must be proactive with these dynasty trusts. Automatic GSTT allocation cannot be trusted because of the sunset provision. File a gift tax return to ensure and document the GSTT exemption allocation.

### **Portability of Deceased Spouse's Unused Exclusion Amount (DSUEA)**

For those dying in 2011 and 2012, the executor of the estate may transfer any unused estate tax exemption to the surviving spouse. It must be done on a timely filed Form 706 Estate Tax Return. Only the most recent deceased spouse's unused exemption may be used by the surviving spouse so a remarriage jeopardizes the original DSUEA. The DSUEA can be used to exempt gifts by the surviving spouse. There is no portability of the GST exemption and, unless Congress acts, DSUEA not used by December 31, 2012, will be lost.

*Example:* Jack and Jill are married and neither has made any taxable gifts. Jack dies in 2011 and leaves his entire \$3 million estate to a bypass trust. His executor elects to permit Jill to use Jack's unused exclusion amount. Jill now has an applicable exclusion amount of \$7 million (her \$5 million basic exclusion amount plus \$2 million DSUEA from her deceased husband, Jack).

*Chapter 2:* After Jack died, Jill married Jerry. Jerry died in 2012, and left his entire \$4 million estate to his children. The \$2 million DSUEA Jill previously received from Jack is wiped out by Jerry's subsequent death. If Jerry's executor makes the election to permit Jill to use Jerry's DSUEA, her applicable exclusion amount is \$6 million (\$1 million less than she had prior to Jerry dying). If Jerry's executor does not make such an election Jill's applicable exclusion amount is just her own \$5 million (\$2 million less than she had prior to Jerry dying).

*Alternate ending:* Same scenario, but Jill dies in 2012 instead of Jerry. Jill left her entire \$3 million estate to a bypass trust; therefore her DSUEA is \$4 million (Jill's \$7 million applicable exclusion amount minus the \$3 million left to the bypass trust). If Jill's executor makes the election, Jerry can use Jill's unused exclusion amount, so his applicable exclusion amount will be \$9 million (Jerry's basic exclusion amount of \$5 million plus Jill's \$4 million DSUEA).

**Concerns:** Open questions under the 2010 Tax Act are, what exemption is applied to gifts by one holding a DSUEA, and how? Is the DSUEA used first or one's own exemption? If there is an election, how will it be made?

**Planning Tip:** With the new portability option, clients may think they do not need to include a bypass trust in their planning. That is dangerous thinking. As professionals, we need to communicate that there are still many benefits and reasons to use a bypass trust, including:

- Asset protection;
- Certainty and control for the first spouse to die over how his/her share of the assets will be managed and distributed;
- Protection of the assets in event of a remarriage;
- Maximize and preserve GST exemption (portability only applies to gift/estate tax exemption);
- Increase in value post death;
- State estate taxes (portability is a federal provision and is not applicable to state laws);
- Income shifting down to other beneficiaries who might be in a lower tax bracket;
- A DSUEA is not indexed for inflation; and
- Portability may end and any unused DSUEA lost on December 31, 2012.

Bottom line: bypass trust planning is proven, advantageous and reliable. DSUEA reliance is none of those plus compels filing an estate tax return even for non-taxable estates.

### **Charitable Donations from IRAs**

Previously, those who wanted to make a contribution from their IRA to charity would have a check issued to them, make the donation to the charity, then pay income tax on the distribution and take the charitable deduction. For 2011, those over age 70 1/2 may make tax-free distributions up to \$100,000 (\$200,000 if married) directly from their IRA accounts to charity and counted against their Required Minimum Distribution (RMD) for 2011. (No tax paid, no deduction.) Donations made in January 2011 may also be counted as having been made in 2010 and applied to any unmet 2010 RMD obligation.

### **Dealing with the Uncertainty**

Over the next two years, we can expect that the estate tax will remain a political football; the House Democrats have already complained that the estate tax exemption is too generous, President Obama suggested increased taxes for the wealthy in his State of the Union Address, and major tax reform hearings are already planned for 2011 in both the House Ways and Means and the Senate Finance Committees. Possibilities during this time include:

- Present legislation, with the \$5 million exemption and 35% tax rate, will be made permanent.
- EGTRRA's 2009 regime, with a \$3.5 million exemption and 45% tax rate, will be extended permanently. (This has already been proposed by the House Democrats.)
- Congress may do nothing, in which case 2013 will bring a \$1 million exemption and 55% top tax rate. (This should be incorporated as a possibility in planning.)
- There could even be "permanent" repeal of the estate, gift, and GST taxes. With the \$5 million exemptions and 35% tax rate, little revenue will be coming in from them, making them less painful to eliminate.

Practical planning applications can include:

- Increased use of trust protectors with amendment power to deal with tax changes coupled with a grantor's statement of intent (to minimize estate taxes, maximize benefits to spouse, etc.);
- Decanting provisions, coordinate drafting with state law;
- Authorizing the trust protector power to grant a beneficiary a general power of appointment (with higher exemption amounts, it may be advantageous to include property in beneficiary's estate to receive step-up in basis);
- Including formula testamentary general powers of appointment;
- In decoupled states, funding the marital share with sufficient property to reduce both federal estate tax and state death taxes to lower amount (can divide marital share into two QTIPs);
- Having a contingency plan built in for possible repeal: all to a QTIP, all to a bypass trust, percentage division into marital and non-marital shares, etc.

### ***Implementing a Client Maintenance Program***

Estate plans that are being written today may not be used for another 15-20 years. Most of them will need revisions during that time. Rather than terminating the relationship when the documents are delivered and signed, a number of practitioners have implemented client maintenance programs for continuing the engagement. This increases the likelihood that the client's estate planning objectives will be achieved, provides an opportunity to review funding and beneficiary designations, and decreases the advisors' liability risk by strengthening the relationship with the client.

### **Conclusion**

With the gift, estate and GSTT exemption so high for the next two years, there is a concern that the public will think there is no need to do any estate planning. All estate planning professionals can re-educate the public about the non-tax reasons to do estate planning, which are ultimately more important than the tax reasons, and the risks of deferring planning. Remember that we are more than planning technicians or document drafters or sellers of product. Most of us are in this field because we want to help clients use, preserve, protect and transfer their wealth responsibly, in order to provide for themselves and their children, and to perpetuate their goals, dreams and values for future generations.

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