Transfer Tax Law Changes; GST Planning Available Only in 2010

December 21, 2010

The new federal tax law presents an extraordinary wealth transfer opportunity, but the generation-skipping transfer tax sale ends December 31, 2010.

It's old news now that late last year the U.S. Congress allowed the estate and generation-skipping transfer (GST) taxes to lapse for 2010. You've likely read reports of the several billionaires who died in 2010 and left estates that escaped estate tax.

On Friday, December 17, 2010, President Obama signed into law a tax bill that resolves—at least temporarily—much of the uncertainty regarding the transfer tax system. If Congress had not acted before year end, on January 1, 2011, the estate tax would have returned after the 2010 "gap" year to 2001 law, which imposed the estate tax at a top tax rate of 55 percent to be applied after an exemption of $1 million. Back too would have been the GST tax at a flat 55 percent rate, and the gift tax rate, which today is imposed at 35 percent, would have risen to a top rate of 55 percent.

The new tax law provides for the following:

- Generation-skipping transfers made in 2010 are taxed at 0 percent. This includes gifts made in 2010 to grandchildren or other "skip persons," such as great-grandchildren, grandnieces or grandnephews, as well as trust distributions or other taxable events with respect to a trust that occur in 2010. In addition, each person's "GST exemption" was increased to $5 million and can be allocated to any gifts made in 2010 during life or at death that remain in trust and will pass down more than one generation level. Each person's GST exemption continues as before to be reduced by any exemption used previously.
- For 2010 gifts, the gift tax exemption remains at $1 million and the gift tax rate remains at 35 percent.
- In 2011 and 2012, the estate and gift tax will be imposed at 35 percent after an exemption of $5 million per person (this cumulative exemption includes all prior gifts by a person). The GST tax also will be applied at 35 percent after an exemption of $5 million. An inflation adjustment will be applied to the $5 million exemption amounts for 2012.

- For those who died in 2010, the executor can elect to tax the decedent's assets at 35 percent after an estate tax exemption of $5 million, in which case the assets will receive a "stepped up" income tax basis equal to their fair market value at death. Alternatively, the executor can elect out the estate tax regime, in which case no estate tax would be paid and the modified carryover basis rules would apply to determine the recipients' income tax basis in the assets.
- For IRA owners over age 70½, tax-free distributions of up to $100,000 per year through 2011 can be made to charity directly from the IRA. Charitable transfers from the IRA during January 2011 can be treated as being made in 2010.
- The reversion to the 2001 transfer tax rates and exemptions described above is postponed until January 1, 2013.

No Generation-Skipping Transfer Tax in 2010

For those who want to benefit grandchildren or more remote descendants, the 0 percent GST tax rate is a compelling reason to complete those transfers in 2010. Even though the transfers would be subject to a 35 percent gift tax, the complete avoidance of an additional 35 percent GST tax that otherwise might apply to comparable transfers in 2011 and later makes the math easy. For example, if a 35 percent rate applies, deploying $10 million to cover the gift and gift tax in an outright transfer to a grandchild nets the grandchild about $7.4 million, with the remaining $2.6 million going to pay gift tax. Assuming a donor's remaining GST exemption is allocated elsewhere, that same $10 million deployed in 2011 at a 35 percent transfer tax rate nets the grandchild only $5.49 million, with the other $4.51 million going to pay the gift and GST taxes.

This GST tax benefit also applies to gifts made in trust before the end of 2010—the gift need not be made outright to the beneficiaries. Although the trust would be held for grandchildren initially, after a period of time it may be possible to allow the donor's children to benefit from the trust. The trust would be designed to eventually be distributed to the grandchildren because under this particular quirk in the law distribution to the next younger generation would attract GST tax. This same approach could be used where the initial beneficiaries are great-grandchildren.

A comparable opportunity for avoiding the GST tax applies to distributions made in 2010 from certain existing trusts (that are not exempt from the GST tax) to grandchildren, great-grandchildren, grandnieces or grandnephews. If such a distribution would in other years attract

GST tax, it can be made in 2010 without imposition of that tax or the use of GST exemption if the trust terms permit the distribution. In some cases, it may be possible to make the distributions to a new trust for the beneficiaries.

"Turbo-Charge" Generation-Skipping Transfers in 2010

One variety of a "grantor trust" is an irrevocable trust funded with a gift from the grantor that has the following two characteristics: the trust assets are out of the grantor's estate and will not be subject to estate tax at the grantor's death, and the income on trust assets is taxed directly to the grantor as if the grantor still owned the assets. The Internal Revenue Service ruled definitively that in such circumstances the grantor's payment of the income tax on the trust's income, albeit an economic benefit to the trust and its beneficiaries, is not a taxable gift by the grantor.

By making a 2010 transfer, like that described above, into a grantor trust rather than outright to the beneficiaries, the donor can enhance the value to the beneficiaries on a gift tax-free basis as long as the donor lives. Over a long period of time, the additional gift tax-free value can be substantial.

Who Should Consider a Significant Generation-Skipping Gift Before Year End?

Those who should consider generation-skipping gifts in 2010 include just about anyone who has assets to spare and wants to benefit grandchildren, great-grandchildren, grandnieces or grandnephews in an amount that exceeds the donor's remaining balance of his or her $5 million GST exemption. However, older persons or persons in ill health with large estates that will or should pass to grandchildren stand out as particularly compelling candidates for significant year-end gifts. Although the math is the same regardless of a person's age or health, an impending estate tax levy may make a less costly gift tax more palatable, especially given the complete avoidance of the GST tax.

Where there is concern that the donor may die before year end, the gift may be deferred until the very end of this year. That way if the donor does die in 2010, there will be no estate tax or GST tax and the gift tax will not have been unnecessarily incurred.

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Key Concepts

- Gifts to grandchildren or great-grandchildren in 2010—whether outright or in trust—completely avoid the GST tax that is scheduled to reappear in 2011.
- Making the gift to a grantor trust that causes the donor to pay the income tax as a gift tax-free benefit to the trust beneficiaries enhances the value of the gift.

Stay Tuned for Further Planning Updates

There have been significant modifications to the transfer tax system over the last decade, and the new tax law provides clarity only through 2012. There is no telling what may happen following 2012, and the $5 million gift (starting in 2011) and GST tax exemptions provide a significant opportunity to create trusts that can pass from generation to generation without the imposition of gift, estate or GST taxes. Additional updates will be provided in 2011 to address planning considerations for 2011 and 2012.