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Wealth Transfer Planning Considerations for 2011 and 2012

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The new federal transfer tax law provides unprecedented planning opportunities for 2011 and 2012.

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Act). In addition to extending Bush-era income tax cuts, the 2010 Tax Act resolves some of the uncertainty surrounding the future of the federal transfer tax system. By increasing exemption amounts, the 2010 Tax Act provides taxpayers over the next two years with both planning opportunities and cause to reexamine their estate plans.

For 2011 and 2012, the 2010 Tax Act makes the following changes to the federal transfer tax system:

- **Estate Tax**. The top estate tax rate is now 35 percent (down from a top rate of 45 percent in 2009), and each taxpayer will have $5 million of estate tax exemption (which is reduced to account for prior use of exemption to shelter lifetime taxable gifts). An individual's unused estate tax exemption amount may be "portable" and used by a surviving spouse (see below).

- **Gift Tax**. For 2011 and 2012 gifts, the 35 percent gift tax rate in effect for 2010 transfers is extended. In addition, the 2010 Tax Act re-unifies the estate and gift tax exemption amounts at $5 million, providing taxpayers with additional opportunity to make lifetime transfers without incurring gift tax. Beginning in 2012, the estate and gift tax exemption amounts will be adjusted for inflation. Before 2011 lifetime transfers by taxpayers were constrained by a $1 million gift tax exemption amount.

- **GST Tax**. The generation-skipping transfer (GST) tax rate is also 35 percent (down from the 45 percent rate in effect in 2009), and each taxpayer will have $5 million of GST exemption (up from $3.5 million in 2009) applicable both to lifetime and testamentary transfers. Beginning in 2012 the GST exemption amount will be adjusted for inflation.

- **Portability**. If an individual dies during 2011 or 2012 and does not have sufficient assets in his or her estate to use the full $5 million estate tax exemption, that individual's surviving spouse may use the "unused exemption" through lifetime gifts or through transfers at the surviving spouse's death. The new law does not provide for the portability of unused GST exemption.

- **Sunset**. The new transfer tax rules will apply to transfers made in 2011 and 2012. Absent additional action by Congress, on January 1, 2013, the tax law in effect prior to 2001 will return: a top 55 percent tax rate for estate, gift and GST taxes, and $1 million estate, gift and GST tax exemption amounts (with the GST exemption amount adjusted for inflation since 2001).

Review Estate Plans in Light of Potential Changes

Many estate plans feature formulas tied to estate and GST exemption amounts. The amounts passing under these formulas could vary widely over the next few years because of the possibility of increased exemption amounts under the new law, of the return starting in 2013 to lower exemption amounts and higher tax rates or of repeal of the federal transfer tax system. Another factor under these formulas is their treatment of state estate taxes, which also are changing. In short, virtually every estate plan needs to be reviewed in the context of these different transfer tax scenarios to ensure the plan produces the intended result in a fluctuating tax environment.

The medium and long-term uncertainty about the federal transfer tax system also puts a premium on incorporating flexibility in irrevocable transfers. Flexibility may be provided through trust provisions or powers that enable some party to address future changes in the tax law in a manner consistent with the transferor's intent.

Wealth Transfer Opportunities

The increased gift and GST tax exemption amounts have created a significant wealth transfer opportunity. In 2011 and 2012, in addition to any used portion of the former $1 million gift tax exemption, each individual can now transfer an additional $4 million (and married couples an additional $8 million) of gifts without incurring gift tax. Making lifetime gifts removes all future income from and appreciation on the transferred property from a donor's taxable estate, which could result in significant estate tax savings. In addition, the use of lifetime gifts can also yield state transfer tax savings because many states continue to impose separate estate and GST taxes, while only a few have their own gift tax. Moreover, the uncertainty about whether the increased exemption amounts will extend beyond 2012 makes it important to consider taking advantage of this wealth transfer opportunity over the next two years.

The increased gift and GST tax exemption amounts also provide an opportunity to create or supplement trusts that can pass wealth to successive generations without being subject to gift, estate or GST taxes under current law. One option for leveraging additional gift and GST tax exemption is through the use of sales to "grantor trusts," irrevocable trusts which are excluded from the grantor's taxable estate but which are taxable to the grantor for income tax purposes. Assets transferred to grantor trusts are, in effect, allowed to grow tax-free because the grantor is obligated to pay income taxes attributable to the trust assets. With the interest rates that apply to these sales at historic lows, sales to grantor trusts remain a powerful method for transferring appreciation out of one's estate.

In addition, Grantor Retained Annuity Trusts (GRATs) remain an attractive planning tool in the current low interest rate environment. GRATs are trusts that pay the transferor an annuity for some fixed time period, with the annuity payout based on an IRS-published interest rate for the month in which the GRAT is funded. At the end of the GRAT term, if the transferor has survived the term, any remaining assets are transferred to the desired transferees without the imposition of gift or estate tax. GRATs can still be structured to "zero-out" the value of the taxable gift to the trust, which sets up the possibility of a significant transfer of appreciation without an upfront gift tax liability. Although several bills introduced in 2010 would have restricted the use of GRATs by imposing a minimum 10-year term and requiring an initial taxable gift greater than zero on creation, the new tax law does not feature any changes to the rules governing GRATs.

When considering assets to transfer, taxpayers should focus on those with significant potential for long-term appreciation or with a high income tax basis (because lifetime transfers do not result in a "step up" in tax basis as do transfers at death). Interests in closely held entities are also attractive assets to maximize the use of additional exemption, because current law may support the use of valuation discounts when determining the value of such interests for gift tax purposes. Taxpayers may also consider using additional exemption to forgive intrafamily loans.

Don't Bank on Portability

Given the uncertainty over whether portability of the estate tax exemption will exist beyond 2012, and the non-portability of the GST exemption, married individuals seeking to maximize multigenerational wealth transfers should still consider transferring sufficient assets to each spouse to maximize the use of the estate and GST tax exemptions. For lifetime transfers, married individuals may continue to split gifts for gift and GST tax purposes and thus aggregate both spouses' gift and GST exemption amounts even if the transferred assets are owned by one spouse alone.

Reconsider Disclaimers of 2010 Transfers

For property transferred as a result of someone's death in 2010, the new law extends the standard nine-month period in which individuals may "disclaim" or refuse an interest in that property until September 19, 2011. For federal tax purposes, a disclaimer that satisfies certain requirements will relate back to 2010, and result in the individual making the disclaimer being treated as though he or she never received the property. Depending on the structure of the deceased individual's estate plan, this extended disclaimer period may provide an additional opportunity to transfer wealth down a generation while avoiding the GST tax (because generation-skipping transfers made in 2010 are taxed at a 0 percent GST tax rate).

In addition, the standard nine-month disclaimer window is still open for many of the lifetime transfers made in the last three quarters of 2010. Subject to certain restrictions, disclaimers may provide an opportunity to undo 2010 gift transfers to avoid the payment of gift tax so that the increased gift tax exemption available in 2011 and 2012 may be used to shelter those gifts.

Items to Be Aware of

To ensure the full increased GST tax exemption of up to $5 million is available to use for transfers in 2011 and 2012, it is essential that transfers made in 2010 either directly to grandchildren or in certain trusts for their benefit are properly reported on 2010 gift tax returns. Taxpayers who fail to “opt out” of the automatic allocation of GST exemption for certain lifetime transfers made in 2010 may inadvertently use some of the increased GST exemption on transfers that would not have been subject to a GST tax because of the zero GST tax rate applicable in 2010.

Individuals considering gifts in 2011 and 2012 also should be aware that, because of the way federal estate tax liability is computed, a portion of the benefit of sheltering transfers under the new $5 million gift tax exemption could be “recaptured.” That is to say that the estate tax on the remaining portion of the estate may be higher than it otherwise would have been had the gifts not been made. This technical glitch may be fixed before 2013. But even if it is not, in most circumstances it will still have made sense to have taken advantage of the increased gift and GST tax exemptions under the 2010 Tax Act.

Finally, a few states still impose gift taxes. So in the zeal to take advantage of the increased federal gift tax exemption, the application of state gift tax should be checked to avoid surprise.

Conclusion

- The changes introduced by the new tax law, and the uncertainty about the transfer tax system beyond 2012, make it important to re-assess existing estate plans and understand how changes in the law could impact those plans, especially those with tax-denominated formula dispositions.
- The increased gift and GST tax exemptions provide major planning opportunities in 2011 and 2012 that may not be available in later years. The amount of wealth that may be transferred out of one’s estate today because of the increased exemptions may be enhanced or “leveraged” through various planning techniques that benefit from today’s low interest rate environment.