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ESTATE PLANNING UPDATE

Important Tax Law Changes Retroactive to January 1, 2010

December 17, 2010 marked the passage of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (referred to in this Update as the "2010 Act"). This Estate Planning Update highlights the impact of the 2010 Act on the Federal gift, estate and generation-skipping transfer ("GST") tax, as well as the estate planning implications of the new law.

Temporary Estate Tax Relief:

The changes made by the 2010 Act are favorable to taxpayers. The new law, however, is temporary in nature. The changes made by the 2010 Act expire as of January 1, 2013. Thus, in the absence of additional legislation, the Federal gift, estate and GST tax system will be restored to the 2001 (pre-Economic Growth and Tax Relief Reconciliation Act of 2001, or "EGTRRA") status which provides for only a $1 million Federal estate exemption, indexed for inflation.

Estate Tax Relief:

Pursuant to the 2001 EGTRRA legislation, the Federal estate tax was not applicable to individuals dying in 2010. For decedent's dying in 2011 and thereafter, the Federal estate tax would apply at pre-EGTRRA rates, namely, a maximum 55% estate tax bracket and an exemption of $1 million indexed for inflation. In lieu of the estate tax applying to the estates of decedents dying in 2010, there would be a "carryover basis" regime as opposed to a "step up" in basis. Under the historic "step up" system, potential capital gains would be eliminated on most assets inherited by heirs. With "carryover basis," instead of the estate tax, heirs would inherit assets subject to the potential capital gains that would have been incurred by the decedent had he or she sold the subject assets during lifetime, subject to a general $1.3 million statutory basis step-up and $3 million spousal basis adjustment that could be allocated by the decedent's executor.

Under the 2010 Act, the Federal estate tax, by default, is applicable to individuals dying in 2010, and a $5 million estate tax exemption applies. The $5 million Federal estate tax exemption will also apply to the estates of individuals dying in 2011 and 2012. However, the executor (or other

personal representative) of the estates of individuals dying in 2010 may elect out of the Federal estate tax and apply the "carryover basis" rules instead of the estate tax. For estates in excess of $5 million, such election generally will provide overall tax savings as capital gains on the sale of estate assets (at least under the current law) would be taxed at 15%, as opposed to the new 35% maximum estate tax bracket that remains in effect for decedents dying between January 1, 2010 and December 31, 2012. The 2010 Act also reinstates the GST tax and no election is available to opt out of the GST tax.

Filing Dates For 2010 Decedents:

For individuals dying prior to the date of enactment of the 2010 Act, the dates for filing an estate tax return, making a basis allocation (if the executor elects out of the estate tax), paying estate taxes and making disclaimers, is extended until September 17, 2011. Note that a "qualified disclaimer," to be valid for Federal tax purposes, must be valid under state law. Most states (but not New Jersey) impose a 9-month deadline, measured from the date of death, in order to make a valid disclaimer. Thus, the extension provision under the 2010 Act as it relates to disclaimers may not be useful to certain 2010 estates.

Changes in Rates and Exemptions:

The new estate tax exemption is $5 million. Thus, estates of individuals dying in 2010, 2011 and 2012 having a net value of $5 million or less will not pay Federal estate tax. In addition, the $5 million exemption will be indexed for inflation in 2012.

For purposes of the Federal gift tax, for gifts made in 2010, the gift tax exemption was unchanged by the 2010 Act and remained at $1 million. However, the 2010 Act increased the Federal gift tax exemption for gifts made in 2011 and 2012 to $5 million. The maximum gift tax rate for gifts made in 2010, 2011 and 2012 is 35%.

The GST tax exemption is also $5 million under the 2010 Act for generation-skipping transfers occurring in 2010, 2011 and 2012. GST transfers made in 2010 have a tax rate of zero but all other GST rules still apply to 2010 generation-skipping transfers.

"Portability":

"Portability" applies only to decedents dying in 2011 and 2012. If a married individual fails to engage in estate planning during lifetime and leaves all of his or her assets to a surviving spouse, generally there is a wasting of the estate tax exemption available to that individual's estate. Fundamental estate planning for married individuals incorporates the use of certain trust planning so that each spouse may make use of his and her respective estate tax exemption. Under the "portability" rules, if an individual fails to plan during lifetime and would otherwise have lost the ability to utilize his or her estate tax exemption, the surviving spouse may utilize both his or her own estate tax exemption and, in addition, the otherwise "wasted" estate tax exemption that would have been available to the estate of the first spouse to die. This requires an affirmative election in the estate of the first spouse to die; there is nothing "automatic" to portability.

This provision will be helpful for individuals who fail to engage in estate planning and happen to die in 2011 and 2012. In addition, unless the law is amended, both spouses must die in 2011 or 2012 in order to have the benefit of portability. Thus, portability as a planning tool is of limited utility.

In addition, portability is a Federal concept only and to the extent that a married couple fails to engage in estate planning, portability will not serve to allow use of the state estate tax exemption otherwise available to the estate of the first spouse to die. Of course, relying on portability ignores the other estate planning benefits of trusts, such as control of when assets are distributed and how they are invested, and protection of assets from the creditors of heirs, including spouses in the event of divorce.

Planning Opportunities Under the 2010 Act:

Since the provisions of the 2010 Act expire as of January 1, 2013, the new law presents a short window of opportunity for planning. Clearly, the increase in the amount that may be gifted during lifetime (gift and GST tax-free) to $5 million presents an excellent planning opportunity for 2011 and 2012. For individuals who exhausted their prior-law $1 million gift tax exemption, the ability to transfer an additional $4 million without tax implications is now available. The making of such gifts in "dynasty" (long-term) trust provides the opportunity to remove assets and the future appreciation and income in such assets from the gift and estate tax system for multiple generations.

If an individual is likely to die in 2011 or 2012, his or her estate plan must be reviewed to determine whether it takes full advantage of the $5.0 million exemption and, if applicable, the portability of that exemption. But for the great majority of our clients, who intend to live well beyond 2012, the temporary nature of the estate and gift tax changes means that the latest tax Act cannot be relied upon for long-term planning purposes. Congress will likely revisit the estate, gift and GST taxes in late 2012, and we cannot predict what action will be taken at that time. Nevertheless, for those who have been reluctant to engage in any estate planning in light of the legislative uncertainty and the possibility of Federal estate tax repeal, now is the time to revisit your estate planning documents with a view toward determining appropriate strategies. We would be pleased to meet with you and discuss your options.

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