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Estate Planning Opportunities and Pitfalls Created by the 2010 Tax Relief Act

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On December 17, 2010, President Barack Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act). The Tax Relief Act makes dramatic changes to the estate, gift and generation-skipping transfer tax laws for 2011 and 2012, and perhaps beyond, depending upon what Congress does when the changes made by the act expire after the end of 2012.

The Tax Relief Act also makes many changes and presents several options applicable only to the estates of those who died in 2010. A discussion of those changes and options is beyond the scope of this article. Individuals who are beneficiaries or fiduciaries under wills or trust instruments of those who died in 2010 should consult their legal, financial and accounting advisors without delay.

Lower Rates and Higher Exemptions for 2011 and 2012

For estates of individuals dying in 2011 or 2012, the Tax Relief Act reduces the top federal estate tax rate to 35%. In 2009, it had been as high as 45% and there was an exemption of $3,500,000. Not only does the Tax Relief Act reduce the top tax rate to 35%, but it also increases the amount that can pass free of federal estate tax to $5,000,000 for 2011 and 2012, with a further inflation adjustment increase possible for 2012.

Similar changes are made to the federal gift tax rules. Many years ago, the gift and estate tax rates were unified; that is, they shared a single exemption and were subject to the same rates so that gifts made during life reduced the amount that the donor could leave free of estate tax at death. This was not the case in recent years, when the gift tax exemption had fallen to $1,000,000. For 2011 and 2012, the gift tax and estate tax are unified once again, with a combined $5,000,000 exemption and a top tax rate of 35%.

Generation-skipping transfer (GST) tax is an additional tax imposed on transfers that "skip" a generation, such as gifts and bequests to grandchildren whose parents are still alive. The Tax Relief Act lowers the GST tax for 2011 and 2012 by increasing the exemption amount from $1,000,000 to $5,000,000 (as indexed for inflation for 2012) and reduces the GST tax rate from 45% to 35%.

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The various rules discussed above relate only to the *federal* estate, gift and GST taxes. Many states, including Connecticut, New York, New Jersey and Pennsylvania, have their own tax rules and rates, often subjecting estates and gifts to state tax on transfers that are far lower than the $5,000,000 exemption levels under federal law. Nevertheless, the changes made by the Tax Relief Act may present attractive planning opportunities.

Why Existing Estate Planning Instruments May Need Review

In order to make sure that all federal estate tax is avoided until after the death of a surviving spouse, while at the same time taking full advantage of the maximum federal estate tax exemption, the estate plan of a married couple often uses a formula clause providing that an amount equal to the maximum available federal estate tax exemption in effect at death will pass to a credit shelter trust upon the death of the first spouse, and that the balance of the estate be distributed outright to the surviving spouse or held in a trust for the spouse that will qualify for the marital deduction. Sometimes, family members other than the surviving spouse are the beneficiaries of the credit shelter trust.

A formula clause is usually used rather than referencing a specific dollar amount in order to avoid the need to revise the will or trust agreement every time the law changes. However, now that the federal estate tax exemption has increased to $5,000,000 (at least through 2012), some unintended consequences could result and the desired amounts may pass to the wrong beneficiaries. For example, if an estate consists of $7,000,000 and utilizes the formula described above, with the credit shelter trust for the benefit of the children and the balance (or "residuary estate," as it is called), passing to the spouse, under current law $5,000,000 would be set aside in the trust for the children and only $2,000,000 would pass to the surviving spouse.

Readers should consider their estate plans and contact their legal advisors to arrange for a review of their estate planning documents. A review may reveal that the documents do not need any changes, or are in need of substantial changes or need to be amended to provide a maximum dollar amount passing to the credit shelter trust.

Portability

Under the Tax Relief Act, any portion of the $5,000,000 estate tax exemption that remains unused at the death of a spouse dying in 2011 or 2012 is generally available for use by the surviving spouse in addition to his or her own $5,000,000 exemption. This is one more weapon in the estate planner's arsenal, but for many reasons, including the fact that we do not know if portability will continue beyond 2012, individuals should not place much reliance on portability. Credit shelter trusts and having sufficient assets owned by each spouse continue to be important.

Helpful Tip: *Because of the much lower estate tax exemptions that are in effect in many states, discussed above, it may also be appropriate to reevaluate existing estate plans by calculating how much state estate tax exposure there may be under those plans.*

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