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New Two-Year Gift, Estate And GST Tax Law Enacted

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On December 17, 2010, President Obama signed into law a two-year tax compromise for gift, estate and GST taxes. This unprecedented two-year window provides a significant opportunity for wealth transfer at a reduced tax cost. Clients should consider taking advantage of the new gift, estate and GST tax laws in 2011 and 2012 as there is no certainty that such laws will be extended beyond their current expiration date of December 31, 2012.

This Paul Hastings Client Alert focuses on the changes to the gift, estate and GST tax law under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Relief Act") signed into law by President Obama on December 17, 2010.

Although most actions can or should be deferred to 2011 or 2012, certain actions may require completion by December 31, 2010, as discussed below.

Prior Gift, Estate and GST Tax Law

In 2009, the highest gift, estate and generation skipping transfer ("GST") tax rate was 45 percent. Estate tax is imposed on the value of all property owned by a decedent, wherever situated, in excess of the "estate tax exemption amount". In addition to estate or gift tax, GST tax is imposed on the value of all transfers to grandchildren (or individuals at least two generations younger) in excess of the "GST tax exemption amount". The estate and GST tax exemption amount in 2009 was $3.5 million per person ($7 million per couple) and the gift tax exemption amount was $1 million per person ($2 million per couple). In 2010, the estate tax was repealed for decedents dying during 2010. Prior to the passage of the 2010 Tax Relief Act, the law was set to revert, in 2011, to the onerous levels last seen in 2001 – a top gift, estate and GST tax rate of 55% with a $1 million exemption per person ($2 million per couple).

Current Gift, Estate and GST Tax Law Under the 2010 Tax Relief Act

Modifications to the estate and GST tax provisions generally are effective as of January 1, 2010. Modifications to the gift tax and other new rules generally are effective on January 1, 2011.

	2010 (Exemption Amount, Tax Rate)	**2011-2012** (Exemption Amount, Tax Rate)	**2013** ***Without Interim Congressional Action*** (Exemption Amount, Tax Rate)
Estate Tax	$5 million, 35% OR No Estate Tax*	$5 million, 35%	$1 million, 55%**
GST Tax	$5 million, 0%	$5 million, 35%	$1 million, 55%**
Gift Tax	$1 million, 35%	$5 million, 35%	$1 million, 55%**

* Executors of estates of decedents dying prior to December 17, 2010 have the option of electing into the pre-2010 Tax Relief Act law, which allows for no estate tax and a limited basis adjustment.

** Without further legislation, the law is scheduled to revert to 2001 levels on January 1, 2013.

Estate Tax Exemption and Rate

As of January 1, 2010, for three years, the top tax rate for the estate and GST tax is 35%, with a $5 million exemption per person ($10 million per couple). In addition, the "stepped up basis" rules under Internal Revenue Code Section 1014 apply to eliminate the recognition of income on any appreciation of the property that occurred prior to the decedent's death.

The Portable Estate Tax

For the first time, the estate and gift tax exemption amounts will be "portable" between spouses. Surviving spouses may use the predeceased spouse's unused gift tax exemption amount to make additional lifetime gifts and estates of decedents dying after December 31, 2010 may apply the predeceased spouse's unused estate tax exemption amount.

For example, assume the estate of a Husband and Wife is $5 million. Husband dies on January 1, 2011 and Husband's estate applies $2.5 million of his estate tax exemption against his $2.5 million community property estate, which passes to his Wife estate-tax free. At Wife's death, the estate has grown to $7 million. Wife's estate may apply her unused $5 million estate tax exemption as well as Husband's unused $2.5 million estate tax exemption, so Wife's estate will not incur estate tax. The same concept will apply for lifetime gifts by the surviving spouse.

Gift Tax Exemption and Rate

The gift tax rate will remain at 35% in 2010, with a $1 million exemption per person ($2 million exemption per couple). On January 1, 2011, for a period of two years, the gift tax is unified with the estate tax, with a 35% rate and $5 million exemption per person ($10 million exemption per couple). Thus, there is no reason to rush to make taxable gifts to children prior to December 31, 2010 solely for purposes of the gift tax rate, which will remain the same through 2012.

Please see below for an important reason to make taxable gifts to grandchildren prior to December 31, 2010, which may not exist in the future, as discussed below.

Gift Tax Exclusions

Certain gifts continue to be excluded from the lifetime gift tax exemption. In 2011, the annual gift tax exclusion will remain at $13,000 per person per donee. This will enable individuals to continue to gift $13,000 ($26,000 for a couple) each year to an unlimited number of donees without such gifts reducing their lifetime gift tax exemption under Internal Revenue Code Section 2053. Annual exclusion gifts are often used for gifts into irrevocable lifetime insurance trusts and trusts for children and grandchildren.

Payments for tuition and medical expenses made directly to educational and medical institutions on behalf of individuals such as children and grandchildren continue to be excluded from the lifetime gift tax exemption. Similarly, gifts to charitable organizations can be made in unlimited amounts without reducing the gift tax exemption.

GST Tax Exemption and Rate

The GST tax rate is at 0% in 2010, with a $5 million exemption per person ($5 million exemption per couple). Beginning January 1, 2011, for a period of two years, the GST tax is also unified with the estate tax, with a 35% rate and $5 million exemption per person ($10 million exemption per couple).

Estate Planning Opportunity Expiring December 31, 2010

The 2010 GST tax rate (0%) presents a unique opportunity for clients to avoid double taxation on substantial gifts to grandchildren (or individuals two generations younger) in excess of $5 million person (or $10 million per couple).

Assume Grandparents want to make a $15 million gift to their grandchildren. If Grandparents make the gift before December 31, 2010, Grandparents' GST tax exemption is reduced to zero and Grandparents must pay gift tax on $5 million at a 35% rate. If Grandparents wait until 2011, Grandparents' GST tax exemption is reduced to zero and Grandparents would face gift tax *and GST tax* on $5 million both at a 35% rate.

Treatment of 2010 Decedents

Prior to the enactment of the 2010 Tax Relief Act, there was no estate tax and a limited basis adjustment for estates of individuals dying in 2010. To avoid any potential hardships associated with the retroactive application of the estate tax in 2010, estates of 2010 decedents may elect to apply the original 2010 law of no estate tax and limited basis adjustment. The election must be made within nine months of the date of enactment of the 2010 Tax Relief Act, but the new form is not yet available. The decision to apply prior law will depend on the valuation of the decedent's assets as of the date of death and the decedent's basis in such assets.

For an estate larger than $5 million comprised mostly of high basis assets, the allocation of basis under modified carryover basis regime may prevent the recognition of income. Thus, in that example, the modified carryover basis regime would result in no estate tax and little, if any, built-in gain for the beneficiaries. Under the 2010 Tax Relief Act, although the beneficiaries would avoid built-in gain due to a stepped-up basis, any amount over $5 million would be subject to estate tax at a 35% rate.

Advanced Planning Continues to Provide Substantial Benefits

The 2010 Tax Relief Act does not impact family limited partnership planning or short-term Grantor Retained Annuity Trust (GRAT) planning and thus, clients should seriously consider both of these options while they are still available.

Family limited partnerships ("FLPs") are commonly used to transfer wealth at a discount for gift, estate and GST tax purposes. GRATs are trusts codified by Internal Revenue Code Section 2702, which are commonly used to transfer the appreciation on assets from parents to children without incurring federal gift or estate tax.

A GRAT enables parents to shift future growth and appreciation of assets to their children without incurring gift or estate taxes. A GRAT involves transferring property that is expected to appreciate significantly over time – such as a closely held business, pre-IPO stock or a private equity investment – to a GRAT trust instrument. In return, the individual who established the trust (the "Grantor") receives an annual annuity payment for each year the GRAT is in existence. The amount of the annuity payment is based on the value of the assets transferred to the GRAT, the number of years the GRAT will exist, and the applicable interest rate mandated by the IRS (known as the Section 7520 rate). At the end of the GRAT term, the assets remaining in the GRAT may be transferred to trusts for the children – often with the parent remaining in control of the assets as trustee.

Many GRATs are limited to a term of 3-5 years because the success of a GRAT depends on two risk factors: (1) whether the Grantor survives the term of the GRAT (the "mortality risk"); and (2) whether the assets transferred to the GRAT outperform the 7520 rate (the "investment risk"). If the Grantor dies during the term of the GRAT, some value of the GRAT assets may be included in the Grantor's

estate for estate tax purposes – thus reducing the tax benefits of the GRAT. As a result, GRATs are often structured with shorter terms in order to minimize the mortality risk.

A shorter 3-5 year GRAT is used to overcome the investment risk. For example, if a parent owns pre-IPO stock or other investment which is likely to increase rapidly in 3-5 years, then the appreciation, through the GRAT trust, can be transferred from the parent to the children. For a longer term GRAT, however, the investment risk increases. If the assets contributed to the GRAT lose value or do not outperform the Section 7520 rate over a longer period of time, such as a 10-year term, there will be no assets remaining in the GRAT at the end of the term to transfer to the children.

To access our June 2008 Client Alert discussing additional wealth transfer opportunities in a low interest rate environment, please visit: http://www.paulhastings.com/publicationdetail.aspx?publicationId=934.

Conclusion

We strongly recommend that you review your existing estate plan and contact us to discuss the impact of the 2010 Tax Relief Act on your planning.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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