The Estate Planner

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2010 Tax Relief act and your estate plan

Short-term answers, long-term questions

After years of uncertainty, Congress has finally determined the fate of the estate tax — temporarily. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 was signed into law on Dec. 17. The act provides lower tax rates, higher exemptions and more flexibility — but only through 2012.

A brief history

The 2001 tax act gradually reduced estate, generation-skipping transfer (GST) and gift tax rates and increased exemption amounts over several years. In 2009, the top rate was 45%, the exemptions for GST and estate taxes were $3.5 million, and the gift tax exemption was $1 million.

In 2010, the act's GST and estate tax one-year repeal went into effect, and the top gift tax rate dropped to 35%. The $1 million gift tax exemption was unchanged. Also in 2010, the stepped-up basis rules were replaced with modified carryover basis rules.

Under a stepped-up basis regime, the tax basis of inherited property generally is increased to its date-of-death fair market value. This allows heirs to sell the property immediately without triggering capital gains tax.

But under the 2001 tax act's modified carry-over basis regime, the estates of people who died in 2010 were permitted to allocate only up to $1.3 million to increase the basis of certain assets, with an additional $3 million for assets left to a surviving spouse. Other assets received a carryover basis — generally equal to the deceased's basis — which could result in significant capital gains tax liability when the assets are sold.

If the 2010 Tax Relief act hadn't been signed into law, then in 2011 the estate, GST and gift taxes would have returned to their pre-2001 tax law levels — that is, a top tax rate of 55%, a $1 million combined exemption for gift and estate taxes, and a $1 million (indexed for inflation) GST tax exemption.

Current state of the estate tax

Under the 2010 Tax Relief act:

- The estate tax is revived for 2010. For 2010 through 2012, the top rate is 35% and the exemption is $5 million.
- The gift tax also applies at a top rate of 35%, but the exemption is $1 million for gifts made in 2010. For gifts made in 2011 and 2012, the gift and estate tax exemptions are reunified in a combined $5 million exemption.

- The GST tax also is reinstated for 2010, also with a $5 million exemption through 2012. But the GST tax rate is 0% for 2010, increasing to a rate of 35% for transfers made in 2011 and 2012.

- The stepped-up basis rules are restored, retroactive to the beginning of 2010.

- For 2011 and 2012, the estate tax exemption is "portable" between spouses. (See "The portable exemption" below.)

The $5 million exemption will be adjusted for inflation for 2012. Some observers interpret this provision to mean that lawmakers foresee an extension of the act's estate tax provisions beyond 2012.

Two options for 2010

For people who died in 2010, the Tax Relief act allows their estates to elect not to apply the new law. In other words, instead of applying the act's 35% estate tax rate, $5 million exemption and stepped-up basis rules, an estate may opt to avoid estate tax altogether and apply the modified carry-over basis rules to assets acquired from the estate.

For 2010 through 2012, the top estate tax rate is 35% and the exemption is $5 million.

Choosing the best option boils down to economics — determining which strategy will likely result in lower combined income and estate tax liability. This will depend on the value of the estate's assets, how much they appreciated while the deceased held them and whether those who receive the assets plan to sell or hold them.

Revisit your plan

The Tax Relief act provides short-term answers to many of the questions surrounding the estate tax during the last several years. But long-term questions remain: Will higher exemptions and lower rates be extended beyond 2012? What about the new portability of the estate tax exemption? How will this ongoing uncertainty affect your estate plan? Talk with your estate planning advisor about whether any changes to your estate plan may be warranted. ✤

The portable exemption

One of the more interesting estate-tax-related provisions of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 is making the $5 million estate tax exemption "portable" for 2011 and 2012. In other words, if one spouse dies without using all of his or her exemption, the surviving spouse can add the unused portion to his or her own exemption and use it to make tax-free transfers during life or at death.

Portability can simplify estate planning, essentially allowing a married couple to maximize the benefits of both spouses' exemptions without complex trust arrangements. To qualify, an election must be made on a timely filed estate tax return for the first spouse to die. Special rules apply to surviving spouses who are predeceased by more than one spouse.

Note that a spouse's generation-skipping transfer tax exemption is not portable, which can complicate things if your estate plan includes bequests to grandchildren. Also, uncertainty over the fate of estate tax exemption portability after 2012 limits its ability to simplify estate plans.

For unmarried couples, estate planning is indispensable

When married couples neglect to prepare an estate plan, state intestacy law provides one for them. It may not be the plan they would have designed, but at least it offers some measure of financial security for a surviving spouse. Unmarried couples, however, have no backup plan. Unless they carefully spell out how they wish to distribute their wealth, a surviving life partner may end up with nothing.

Marriage has its advantages

Because intestacy laws offer no protection to an unmarried person who wishes to provide for his or her partner, it's essential for unmarried couples at minimum to employ a will or living trust. But marriage offers several additional estate planning advantages that unmarried couples must plan around, such as:

Marital deduction. Estate planning for married couples often centers on the marital deduction, which allows one spouse to make unlimited gifts to the other spouse free of gift or estate taxes. Unmarried couples don't enjoy this advantage; thus, lifetime gift planning is critical so they can make the most of the lifetime gift tax exemption and the $13,000 per recipient annual gift tax exclusion.

Unmarried couples also should pay close attention to transactions that may inadvertently trigger gift taxes, such as payment of a partner's living expenses.

Tenancy by the entirety. Married and unmarried couples alike often hold real estate or other assets as joint tenants with rights of survivorship. When one owner dies, title automatically passes to the survivor. In many states, a special form of joint ownership — tenancy by the entirety — is available only to married couples.

In addition to survivorship rights, tenancy by the entirety offers protection against claims by the spouse's individual creditors. Unmarried couples

who seek greater protection against creditor claims should consider placing assets in a trust.

Will contests. Married or not, anyone's will is subject to challenge as improperly executed, or on grounds of lack of testamentary capacity, undue influence or fraud. For some unmarried couples, however, family members may be more likely to challenge a will simply because they disapprove of the relationship.

Here are steps unmarried couples should consider to reduce the risk of such challenges:

- Be sure that the will is carefully worded and properly executed.
- Use separate attorneys, which can help refute charges of undue influence or fraud.
- Include a "no contest" clause, which disinherits anyone who challenges the will and loses.
- Explain in the will the reasons for favoring one's partner over other relatives.
- Use asset-transfer tools that are more difficult to challenge, such as joint ownership, beneficiary designations or trusts.

Health care decisions. A married person generally can make health care decisions on behalf of a spouse who has become incapacitated by illness or injury. Unmarried partners cannot do so without a written authorization, such as a medical directive or health care power of attorney. A durable power of attorney for property may also be desirable, allowing a partner to manage the other's assets during a period of incapacity.

Turning the tables

Although married couples enjoy several estate planning advantages over their unmarried counterparts, there are a few situations in which unmarried couples have an edge. For example, with a grantor retained income trust (GRIT), one partner transfers assets to an irrevocable trust for the other's benefit. By retaining income and certain other interests in the trust, however, the grantor minimizes its value for gift tax purposes.

So long as the grantor survives the trust term, a GRIT has the potential to transfer substantial amounts of wealth tax free, which led Congress in the late 1980s to eliminate these tax benefits for intrafamily transfers. But unmarried couples and other "nonfamily" members can still take advantage of this powerful estate planning strategy.

Unmarried couples should pay close attention to transactions that may inadvertently trigger gift taxes, such as payment of a partner's living expenses.

Careful planning required

If you're unmarried but wish to provide for a life partner, be sure to consult an estate planning advisor to discuss potential strategies. You can achieve many of the same estate planning objectives as married couples, but only with careful planning and thorough documentation. ✤

Happy heirs

An inheritor's trust allows loved ones to both enjoy your assets and protect them

When creating an estate plan, you must consider how estate taxes will affect not only you, but also your heirs who ultimately will receive your assets. Why? Because when they take possession of the assets, the property becomes part of their own taxable estates. To avoid this outcome, your loved ones can have the assets pass into an inheritor's trust.

Assets protected

Having assets pass directly to an inheritor's trust does more than just protect them from being included in the heir's taxable estate. For example, it shields them from other creditor claims, such as those arising from a lawsuit or a divorce. Because the trust, rather than your loved one, legally owns the inheritance, and because the trust isn't funded by the heir, the inheritance is protected.

So if, say, your son is having marital problems and is concerned that his inheritance could one day become marital property, establishing an inheritor's trust can provide asset protection. Everything you gift or bequeath to the trust (including growth and income from the trust) is owned by the trust, and therefore can't be treated as marital property. An inheritor's trust can't replace a prenuptial or post-nuptial agreement, but it can provide a significant level of asset protection in the event of divorce.

With an inheritor's trust, your heirs can also realize wealth building opportunities. If you fund an inheritor's trust before you die, your loved one can use a portion of the money to, for instance, start a new business. A prefunded inheritor's trust can also own the general partnership interest in a limited partnership or the voting interest in a limited liability company (LLC) or corporation. If you decide to fund the trust now, your initial gift to the trust can be as little or as much as you like.

Heir must create the trust

To ensure full asset protection, your heir must set up an inheritor's trust before he or she receives the inheritance. The trust is drafted so that your heir is the investment trustee, giving him or her power over the trust's investments.

Your heir then selects an unrelated person — someone whom he or she knows well and trusts — as the distribution trustee. The distribution trustee will have complete discretion over the distribution of principal and income, which ensures that the trust provides creditor protection.

Your loved one should design the trust with the flexibility to remove and change the distribution trustee at any time and make other modifications when necessary, such as when tax laws change. Bear in mind that the unfettered power to remove and replace trustees may jeopardize the creditor protection aspect of the trust and cause inclusion of the trust property in the heir's taxable estate, unless the replacement trustee cannot be related or subordinate to the heir.

Because it's your heir, and not you, who sets up the trust, he or she will incur the bulk of the fees, which will vary depending on the trust. In addition, he or she may have to pay annual trustee fees. Your cost, however, should be minimal — only the legal fees to amend your will or living trust to redirect your bequest to the inheritor's trust.

Your heir should consult an estate planning attorney to draft the trust in accordance with federal and state law. This will help avoid potential IRS audits and court challenges — and maximize the trust's asset protection benefits.

Best intentions, positive outcome

You had your loved one's best intentions in mind when you named him or her as a beneficiary of your assets, but this may not always be best for your heir. To reduce his or her estate tax liability after inheriting your wealth and protect that wealth from creditors, suggest an inheritor's trust. Your heir likely will be doubly happy with the outcome. ✤

Estate Planning Red Flag

You don't know whether to file a gift tax return

The rules surrounding gift tax returns can be confusing, so let's review some general guidelines.

A federal gift tax return (Form 709) *is* required if you:

- Make gifts of present interests — such as an outright gift of cash, marketable securities, real estate or payment of expenses other than qualifying educational or medical expenses (see below) — *if* the total of all gifts to any one person exceeds the annual exclusion amount ($13,000 in 2010 and 2011),
- Make split gifts with your spouse,
- Make gifts of present interests to a noncitizen spouse who otherwise would qualify for the marital deduction, *if* the total exceeds the annual exclusion amount ($134,000 in 2010 and $136,000 in 2011),
- Make gifts of *future* interests — such as certain gifts in trust and certain unmarketable securities — in any amount, or
- Contribute to a 529 plan and elect to accelerate future annual exclusion amounts (up to five years' worth) into the current year.

No gift tax return is required if you:

- Pay qualifying educational or medical expenses on behalf of someone else *directly* to an educational institution or health care provider,
- Make gifts of present interests that fall within the annual exclusion amount,
- Make outright gifts to a spouse who's a U.S. citizen, in any amount, including gifts to marital trusts that meet certain requirements, or
- Make charitable gifts and aren't otherwise required to file Form 709 — if a return is otherwise required, charitable gifts should also be reported.

In some cases it's advisable to file Form 709 to report *nongifts*. For example, suppose you sell assets to a family member or a trust. Filing a return triggers the statute of limitations and prevents the IRS from claiming, more than three years after you file the return, that the assets were undervalued (and, therefore, partially taxable).

Experience. Responsiveness. Value.

At Shumaker, we understand that when selecting a law firm for estate planning and related services, most clients are looking for:

- A high level of quality, sophistication, and experience.
- A creative and imaginative approach that focuses on finding solutions, not problems.
- Accessible attorneys who give clients priority treatment and extraordinary service.
- Effectiveness at a fair price.

Since 1925, Shumaker has met the expectations of clients that require this level of service. Our firm offers a comprehensive package of quality, experience, value and responsiveness with an uncompromising commitment to servicing the legal needs of every client. That's been our tradition and remains our constant goal. This is what sets us apart.

Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

Shumaker has extensive experience in estate planning and related areas, such as business succession, insurance, asset protection and charitable giving planning. The skills of our estate planners and their ability to draw upon the expertise of specialists in other departments — as well as other professionals — ensure that each of our clients has a comprehensive, effective estate plan tailored to his or her particular needs and wishes.

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We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.

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