

Estate Tax Update

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On December 17, 2010, the President signed “The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” (the “Act”). The Act includes an extension of various provisions of the Bush-era tax cuts, but this article will focus on the changes to the estate tax law.

Contrary to media reports, estate planning in 2011 is not a concern only for high net worth individuals. While the tax planning aspect has always been of particular concern for most people, the basic need for the use of trusts for asset protection, safeguarding family members and addressing personal issues remains paramount. Also, just to complicate the matter more, the Act is only a **two year patch**. Based on the partisanship of Congress in the last few years, it would be impossible to predict how much of this Act will survive after 2013, but for now, the Act provides some excellent planning opportunities.

Estate, Gift and Generation-Skipping Tax

For individuals dying after 2010, the estate tax exemption will be \$5,000,000 per individual for 2011 and 2012 with a tax rate of 35% on the amount exceeding the exemption. The gift tax exemption for the next two years is now unified with the estate tax exemption so that an individual can now gift up to \$5,000,000 without incurring a gift tax. Furthermore, the generation-skipping exemption is also \$5,000,000, which means that a large amount of wealth (up to \$5,000,000 per taxpayer or \$10,000,000 for husband and wife) can now pass down two generations (such as to grandchildren). All three exemptions will be indexed for inflation after 2011.

This does not mean that individuals with assets below this level should ignore estate planning, especially since the exemption and rate are set to revert on January 1, 2013 (absent Congressional action) to their pre-2001 levels of \$1,000,000 and 55%, respectively. Instead, 2011 and 2012 may prove to be the best opportunity to plan to transfer the largest amount of wealth in history and exemplifies the importance of taking advantage of this two year window of opportunity.

In the past, in order to take advantage of the estate tax exemption, the estate planning documents of a married couple would have required the use of a “credit shelter trust”. The first spouse to die would allocate assets equal to the estate tax exemption (\$3,500,000 in 2009 and \$5,000,000 in 2010, 2011 and 2012) in a trust for the surviving spouse so that when the surviving spouse subsequently dies, the amount in trust will then pass to descendants free from estate tax. Beginning in 2011, the concept of portability has been introduced so that if this technique is not used, the surviving spouse has an opportunity to use both exemptions without any advanced planning and can shelter \$10,000,000 from estate tax. While this was meant to facilitate planning, there are a number of serious flaws with relying on this provision:

- Portability only extends to the “last deceased spouse”. In other words, assume Husband dies in 2011 and Wife remarries and New Husband dies in 2012 leaving his estate to his children from his first marriage. When Wife dies, she only has a \$5,000,000 (not a \$10,000,000) estate tax exemption. In essence, there is no ability to “collect” exemptions through remarriage.

- The credit shelter trust can be used as a hedge to ensure that any future appreciation is sheltered from estate tax and that the combined assets of a married couple stay within the \$10,000,000 exemption.
- Portability is set to expire after December 31, 2012. Assume Husband dies in 2011 without sheltering his \$5,000,000 exemption in a “credit shelter trust” and leaves everything to Wife in the hopes that she will be below the \$10,000,000 combined exemption. If Wife dies many years later under a new tax regime with a lower exemption, the couple incorrectly gambled and wasted an opportunity to save estate tax in exchange for simple planning.
- There is no portability for generation-skipping planning, so if the ultimate goal of the estate plan is to keep the assets in the bloodline and away from sons-in-law and daughters-in-law, Wills must have credit shelter trusts.
- Trust planning is still necessary (i) for asset protection purposes since assets in a trust are generally exempt from the creditors of the beneficiary, (ii) to protect from remarriage where the new spouse could receive assets instead of children, (iii) to insulate the surviving spouse from the son-in-law who wants financing for a business venture which may not be a prudent investment, (iv) to provide the surviving spouse with a formal structure to manage the estate assets and avoid mismanagement or (v) to avoid problems if the surviving spouse is unable to manage finances by reasons of dementia or similar disorders.

From a gifting perspective, for individuals who exhausted their \$1,000,000 gift tax exemption under the prior law, they will now have an opportunity to gift another \$4,000,000 of assets in 2011 and 2012. All old gifting plans must be reviewed to determine which additional assets can be given away.

Life Insurance

Since the Act is only a temporary patch, insurance that was purchased to help pay estate tax (also known as survivorship or second-to-die insurance) is still an important planning tool which should be reviewed. It would be drastic to cancel existing coverage based on the assumption that the current tax law is sufficient to avoid estate tax. If laws subsequently change and life insurance has to be repurchased at a future date, changes in health and possible uninsurability may result in overall higher costs, if you are lucky to get the coverage at all. Avoid impulsive decisions and review your coverage with your financial advisor.

State Estate Tax

While the Act makes significant changes for federal purposes, 21 states (notably New York, New Jersey and Connecticut) still impose separate estate taxes. Based on the fact that most states are suffering economically, it is highly likely that state estate taxes in those states will not disappear and planning to minimize state estate tax will become an important issue.

Business Succession Planning

Regardless of exposure to estate taxes, planning to effectively transfer the operations of a closely held business to the next generation is critical. The goal should be to ensure that the individuals who actively

participate in the company are given control of business operations while the family of the deceased owner is compensated for the decedent's equity. Buy/Sell agreements should be reviewed to ensure that the purchase prices in the agreements are consistent with the current value of the company. In the case of family businesses, the \$5,000,000 gift tax exemption is a great opportunity to insulate the business from estate tax as well as the future appreciation.

The Act further proves the proverb that there is nothing permanent except for change. No estate plan can be placed on a shelf and left alone until after an individual dies. The Act provides some wonderful opportunities, but like a television offer, may only last for a short time. Now is the time to review your estate plan to determine whether changes need to be made and whether additional planning is needed.