

## MEMORANDUM

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**Subject:** Overview and Planning Opportunities Under Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

**Date:** March 17, 2011

### **I. General Overview.**

- President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-132) (“2010 Act”) on December 17, 2010.
- Generally, 2010 Act applies through 2012.
- 2010 Act extends the current income tax rate structure (“Bush-era tax cuts”) to all income earners for 2 years and establishes a 2-year estate, gift and generation-skipping transfer tax (“GST”) regime which provides a \$5 million estate, gift and GST exemption per person, with a top rate of 35%, indexed for inflation in \$10,000 increments (from 2010) beginning in 2012.
- Absent 2010 Act, the top four income tax rates that apply to estates and trusts would have been raised by at least 3% each.
- Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), the estate tax was repealed for persons dying in 2010. EGTRRA would have sunset at the end of 2010 and estate, gift and GST exemptions would have dropped to \$1 million, with a top tax rate of 55% after December 31, 2010.
- 2010 Act extends EGTRRA sunset for 2 years, and therefore, unless Congress acts to provide otherwise, beginning January 1, 2013, the estate, gift and GST exemptions will drop to \$1 million, with a top tax rate of 55%.

- 2010 Act also reinstates estate and GST taxes retroactive to January 1, 2010, with a \$5 million estate tax and GST exemption and a 35% top tax rate (with a 0% GST tax rate in 2010). Lifetime gift tax exemption remained at \$1 million for 2010.

## **II. Effect of 2010 Act on Deaths and Other Transfers in 2010.**

- 2010 Act retroactively reinstates federal estate tax for decedents dying in 2010.
  - Each decedent receives \$5 million estate tax exemption (often called the applicable exclusion amount). \$5 million exemption is equivalent to \$1,730,800 estate tax credit.
  - 35% top estate tax rate.
  - Step-up in basis of estate assets to fair market value at date of death.
- Executor of estate may choose to “opt out” of the 2010 estate tax regime and pay no estate tax. At this point there is no guidance on how to elect out, but the IRS should be issuing guidance in the near future. The price of no estate tax is application of the modified carryover basis rules of Internal Revenue Code Section 1022. Note that the GST tax applies with a 0% rate.
  - Modified Carryover Basis Rules: Decedent’s income tax basis in the assets will “carry over” to those who succeed to the property upon the decedent’s death, but the basis cannot exceed the fair market value of the assets as of the date of death (meaning that the basis of an asset will be “stepped down” if it exceeds the fair market value of that asset on date of death). The general rule is that the holding period “tacks.” However, it is unlikely that it tacks if there is a step down in basis.
  - Exception to Carryover Basis.
    - Executor may allocate up to \$1.3 million to increase the basis of assets up to their fair market value on the date of the decedent’s death.
    - In addition, the Executor may allocate an additional \$3 million to increase the basis of assets that pass to the surviving spouse of the decedent.
    - There is an extra basis increase for certain unused and built in losses.
    - Cannot allocate basis to QTIP property of which the decedent was a beneficiary during lifetime, property over which decedent had a power of appointment, or property acquired by decedent by gift within 3 years of death.
- GST Tax Exemption/Rate for 2010.
  - Prior law provided that there was to be no GST tax on 2010 transfers.
  - 2010 Act retroactively reinstates the GST exemption at an exemption level of \$5 million per person as of January 1, 2010 (same as estate tax exemption).

- Although the GST tax was applicable in 2010, the GST tax rate for transfers made in 2010 was 0%.
  - Planning Note. If a generation-skipping transfer was made in 2010 to which the transferor does not want exemption applied (for example, a direct skip with a tax rate of 0%), transferor needs to elect out of the automatic allocation of GST exemption to the transfer.
- Filing (and Tax Payment) Due Dates for 2010 Decedents.
    - For decedents dying after 12/31/2009 and before 12/17/2010, the federal estate tax return, if necessary, must be filed and any disclaimers relating to the estate administration must be made by **September 17, 2011** (9 months after date of enactment of the Act). Because the 17<sup>th</sup> is a Saturday, the deadlines should extend to September 19<sup>th</sup> (a Monday); however, the IRS has not yet confirmed this extension.
    - Otherwise, the due date for filing an estate tax return or making a disclaimer for decedents dying in the last 14 days of December is 9 months from the date of the decedent's death.
    - It is unclear as to when an Executor must file the Application of Increase in Basis for Property Acquired from a Decedent (Form 8939). The latest guidance from the IRS directs that the Form should not be filed with the decedent's final individual income tax return and that the final Form will be published at least ninety (90) days prior to the filing deadline. A draft of Form 8939 is available at <http://www.irs.gov/pub/irs-dft/f8939--dft.pdf>.
    - Possible that Form 706 will need to be filed as well in order to allocate GST exemption.
  - Gift Tax—No changes to the federal gift tax laws for 2010.
    - Individual's lifetime exemption remained at \$1 million (in addition to annual exclusion gifts).
    - Gift tax rate 35% for 2010 gifts.

### **III. Death and Other Transfers in 2011 and 2012.**

- Estate, gift and GST taxes unified in 2011 and 2012.
  - Exemption amount and tax rates are the same for estate tax, gift tax and GST purposes.
  - Top tax rate is 35%.
  - Exemption amount is \$5 million (indexed for inflation beginning in 2012).
- 2010 Act adopts concept of “portability” that allows Executor of deceased spouse to transfer any unused estate tax exemption to the surviving spouse.

- If the surviving spouse is predeceased by more than one spouse, the amount of unused exemption that is available (in addition to the surviving spouse's remaining exemption) is limited to the lesser of \$5 million or the unused exemption amount of the last deceased spouse.
  - Wealthy individuals may take prospective spouse's unused exemption into account when considering remarriage.
  - The ability of surviving spouse to use unused exemption of deceased spouse will require timely filing of an estate tax return (Form 706) for a decedent's estate, even if the estate would not otherwise be required to file an estate tax return. Will the IRS issue a "706-EZ"?
  - Desire to transfer unused exemption may require filing of estate tax return for an estate which would not otherwise be required to file an estate tax return.
  - Portability only applies to decedents dying after 2010; no guarantee that portability will extend past 2012.
  - Portability does not apply to the GST exemption.
  - Portability applies for lifetime gifts as well as transfers at death. Guidance is needed from the IRS on exactly how these rules will be applied.
- Planning Note. Under 2010 Act, for purposes of determining the amount of gift tax that would have been paid on gifts made in prior years, the gift tax rates in effect under Code Section 2001(c) at the time of the decedent's death are used to compute (1) the gift tax imposed with respect to such gifts, and (2) the unified credit allowed against such gifts. So, even if taxpayer has made taxable gifts in excess of the former \$1 million exemption, in 2011 and 2012, the taxpayer will have \$4 million of tax-free gifting available.
  - Tremendous Estate Reduction Opportunity.
    - Husband and wife can now make tax-free gifts of up to \$10 million.
    - Availability of valuation discounts may make this opportunity more valuable.
    - Important to use this opportunity early.

#### IV. Effect of North Carolina Taxes?

- Gift Tax. North Carolina repealed its gift tax effective January 1, 2009.
- North Carolina Estate Tax.
  - A North Carolina estate tax is due on an estate when a federal estate tax is payable. N.C. Gen. Stat. §105-32.2.
  - The North Carolina estate tax is equal to the state death tax credit that was allowable under Section 2011 of the Internal Revenue Code as it existed prior to 2002, but North Carolina estate tax may not exceed the federal estate tax that would be payable if the federal estate tax was computed without regard to the deduction for the state death taxes.

- Limitation was added because North Carolina estate tax is measured by state death tax credit under Code Section 2011, which is calculated based on entire estate, not just amount over \$5 million exemption amount, so in many cases, North Carolina estate tax would have exceeded federal estate tax (See Illustrations below).

## **V. Illustrations of Impact of Higher Exemption on Certain Estates**

- \$6 million adjusted gross estate:
  - Federal estate tax-\$227,500
  - North Carolina estate tax-\$350,000 (Without limitation mentioned above, N.C. estate tax would be \$510,800)
  - Total estate taxes-\$577,500
  - Percentage of total estate taxes to total estate-9.625%
  - Percentage of total estate taxes to portion of estate (\$1 million) that exceeds the exemption amount -57.75%
  
- \$10 million adjusted gross estate:
  - Federal estate tax- \$ 1,376,340
  - North Carolina estate tax-\$1,067,600
  - Total estate taxes-\$2,443,940
  - Percentage of total estate taxes to total estate (\$10 million)-24.44%
  - Percentage of total estate taxes to portion of estate (\$5 million) that exceeds exemption amount -48.88%
  
- \$20 million adjusted gross estate:
  - Federal estate tax- \$4,316,620
  - North Carolina estate tax-\$2,666,800
  - Total estate taxes-\$6,983,420
  - Percentage of total estate taxes to total estate (\$20 million)- 34.92%
  - Percentage of total estate taxes to portion of estate (\$15 million) that exceeds exemption amount -46.56%

## **VI. What the 2010 Act Left Unchanged.**

- No changes were made in the rules regarding Grantor Retained Annuity Trusts (“GRATs”), but stay tuned. Proposed legislation to limit GRATs is a revenue raiser and will be a tempting “add on” to future tax legislation.
- No limitation on use of valuation discounts for (1) lack of marketability; (2) lack of control associated with minority interests in corporations, LLCs and other entities; and (3) fractional interests in real property.
- Deduction against federal estate taxes for state death taxes remains available.

## VII. Planning Opportunities and Challenges under 2010 Act.

- President Obama's 2012 budget proposal contained, among other items, provisions to:
  - Make permanent the 2009 estate rates and exemptions—45% & \$3.5 million.
  - Make portability permanent.
  - Modify rules for valuation discounts.
  - Require minimum 10-year term for GRATs.
  - Limit the term of the generation-skipping transfer tax exemption to 90 years.
- Any clients with tax driven formula clauses in their estate planning documents need to review how those clauses will work with the expanded estate and generation-skipping exemptions.
- In light of the expanded exemptions for estate tax, many clients' plans can be simplified. For example, if the client's preference would be to leave everything to his/her surviving spouse, increased exemptions and portability could make such a provision tax-efficient.
- Issues with 2-year window.
  - Difficulty of drafting documents when exemption amount may be \$1 million or some other amount after 2012.
  - Portability may not exist after 2012.
  - If tax rates increase in the future and/or exemptions are lowered, there could be a loss of the apparent advantages of using these rates and exemptions when estate tax is calculated at the transferor's death (referred to as "Clawback"); however, any Clawback is only speculation at this time.
- "Disclaimer" planning may be best answer for many estates.
  - Leave entire residue to surviving spouse.
  - Surviving spouse can review tax situation at time of first death and decide whether to disclaim part or all of inheritance and allow a by-pass trust to be established (assuming documents are drafted to allow such a result).
- Should couple rely on portability or create by-pass trust in first estate to use exemption amount of first spouse to die?
- Many situations will still warrant a by-pass trust.
  - Asset protection for potential liabilities of surviving spouse (for example, surviving spouse is physician).
  - Ensure eventual disposition of assets to intended beneficiaries of first spouse to die (Ex: second spouse is not parent of one or more of decedent's children).
  - Health or other issues make it unwise to leave assets to surviving spouse.

- The likelihood that certain assets, which could be used to fund a by-pass trust, will appreciate markedly between the decedent's death and the surviving spouse's death.
- By-pass trusts should be drafted so that partial or full distribution can be made from such trusts to the surviving spouse if a step-up in basis at surviving spouse's death is desired and tax policy evolves so that there is no risk of estate tax being imposed on those assets. Other methods to cause estate tax inclusion (in the surviving spouse's estate) of assets initially transferred to by-pass trusts may be considered.
- GST exemption is not portable; need to draft to use GST exemption of first spouse to die if GST planning is important to couple.
- Incentives to proceed with gift transfers early in 2011.
  - Current depressed values of many assets and low interest rates work well with many planning techniques—GRATs, installment sales to grantor trusts, CLATs and low interest loans to family members.
  - Intra-family discounting has not been abolished. Larger exemption gives cushion in case discounted valuations are challenged by the IRS.
- For wealthier clients, because the \$5 million gift and GST exemptions may not be available after the 2-year window closes, gifts may be more desirable than freeze techniques such as GRATs and low interest loans.
- Without regard to tax planning, pour-over wills and revocable trusts will continue to be desirable in order to avoid probate in the administration of estates.

## **VIII. Income Tax Highlights**

- Bush-era tax cuts are extended for 2 years. Top income tax rate remains at 35% (rather than increasing to 39.6%).
- Favorable tax rates for long-term capital gains and qualified dividends are retained for 2 years. The capital gains and qualified dividend rates will remain at 15% for taxpayers in the 25% income tax bracket and above. The capital gains and qualified dividend rates for taxpayers below the 25% bracket will remain at 0%.
- The AMT "patch" is extended for 2 years (2010 and 2011). The AMT exemption amounts for 2010 are increased to \$47,450 for individuals and \$72,450 for married couples filing jointly. For 2011, the AMT exemption amounts will be \$48,450 for individuals and \$74,450 for married couples filing jointly.
- For 2006-2009, a person who owned an IRA and who was 70 ½ could make income tax-free distributions from his/her IRA to qualified public charity. The charitable distribution can count as the IRA owner's required minimum distribution. The Act extends this regime to distributions in 2010 and 2011. The Act also allows charitable donations made in January

2011 from an IRA to count toward the 2010 \$100,000 limit and the 2010 minimum distribution requirement.

- The repeal of the personal exemption phase-out and itemized deduction limitation laws has been extended for 2 years.
- Reduction in “social security payroll tax” by 2% in 2011 for all taxpayers (including self-employed).
- The federal deduction for state and local sales tax has been extended for 2 years (2010 and 2011).



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