

# THE BERNSTEIN REPORT

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Dear Reader,

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was signed into law by President Obama before the end of last year. Along with the extension of the extended unemployment benefits, the bill created a one-year stimulus item with respect to the payroll tax. In lieu of the Making Work Pay tax credit, the employee's share of the OASDI tax will be reduced by 2 percent throughout 2011. This is for all level of wage earners and applies to all earned income up to the Social Security wage base of \$106,800. This stimulus will provide \$120 billion of tax relief in 2011. You may be seeing this in your paycheck by the time you read this letter.

One income-tax extender item that bears mentioning is the reinstatement of the qualified charitable IRA rollover provision. This rule was applied retroactively to 2010 and will apply to charitable IRA rollovers in 2011. The rollover amount may not exceed \$100,000 per taxpayer, per year, and is limited to individuals who have attained age 70 1/2. A special rule permits distributions in January 2011 to be treated as if made in 2010. Unfortunately, the IRS has announced that they will not permit distributions taken in 2010 to be reinserted in the IRA for the purposes of making the 2010 qualified charitable rollover.

A provision affecting deferred annuity policies incorporated in tax legislation earlier in 2010 takes effect for this year. The law now permits a deferred annuity policy to be partially annuitized. If a portion of a deferred annuity contract is annuitized for a period of 10 years or more or for the lives of one or more individuals, that portion of the annuity is treated as a separate contract and the remaining portion of the annuity can remain deferred for federal income tax purposes. This provision does not apply to amounts deferred in qualified retirement plans

The new tax legislation postpones the decision concerning the expiration of so many tax provisions that they could not be listed in the space requirements of this letter. Primarily, the 900 pound gorillas with respect to revenue loss are the AMT patch and the 15 percent rate on long-term capital gains and qualified dividends. The further extension of these provisions is a battle for another day. We'll be here to keep you informed.

Cordially,

*Richard S. Bernstein*

**A Second Opinion Costs You NOTHING,  
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,  
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

# **The Estate, Gift, and Generation-Skipping Transfer Tax Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010**

## **Business as Usual or a New Ballgame?**

The long-awaited (many would say overdue) revision to the federal wealth transfer tax system was enacted in December as a result of a compromise reached between President Obama and Republican Congressional leaders. The uncertain circumstances created by EGTRRA in 2001 resulted from a 10-year legislative window followed by a "sunset" of the changes. The uncertainty continues to some degree because the new revisions will sunset after two years and further extensions or revisions will be required for 2013. It's early in the game with respect to the new tax rules and we're going to provide you with a summary and food for thought about the impact of these rules on estate plans.

## **What about 2010?**

The settlement of estates for deaths occurring in 2010 has been mired with uncertainty for the affected families and the professional advisors. Far too many statements were made by Congressional leaders and estate planning experts with respect to the retroactivity of the federal wealth transfer tax. However, some level of retroactivity actually occurred. For deaths occurring in 2010, the estate has the choice of applying the law as it was written at the time or being taxed under the provisions of the law passed at the end of the year.

The estate could elect to be subject to the modified carryover basis rules provided by EGTRRA and avoid estate taxes. Or, the estate could choose to be subject to the new estate tax rules. Briefly, the modified carryover basis rules would allow the executor of the estate to increase the basis of assets by \$1.3 million. The basis of any individual asset could not be increased beyond the value of the asset as of the date of death. For assets transferred to a surviving spouse in a qualifying manner, an additional \$3 million of basis increase could be applied. If estate taxation is chosen, the estate will have a \$5 million exclusion and the excess will be taxed at a 35 percent tax rate. Furthermore, if estate taxation is chosen, the basis step-up rules will apply to assets and heirs will take these assets with an income-tax basis equal to the date of death value of such assets.

Fortunately, the new law provides for some relief with respect to the return due date for deaths occurring last year. The executor for such estates has until September 17 of this year to file the return. The choice of tax regimes should be clear if the taxable estate is substantially above \$5 million. The 35 percent estate tax rate would be more punitive than the current 15 percent rate on long-term capital gains, so the modified carryover basis/zero estate tax regime should be more favorable. For taxable estates under \$5 million, the estate tax should be chosen because there will be no estate tax and the accompanying basis step-up provisions will eliminate the capital gains potential. A more detailed quantitative analysis that involves some speculation concerning the growth rate of assets and the timing of the sale of the assets by the heirs must be performed for estates just above the \$5 million threshold. An additional consideration that must be factored into the decision is whether the estate is holding assets with a built-in capital loss. This type of decision is not completely unique since we always have had to determine the effectiveness of making gifts prior to death and choosing the appropriate property to give away. The gain or loss potential would indicate the choice of making gifts, incurring losses on property for income-tax purposes, or holding assets until death for the available basis adjustment.

## The New Wealth Transfer Tax System for 2011 and 2012

The exemption amount for estate, gift, and generation-skipping transfer taxes is \$5 million for 2011 and 2012 with the 2012 amount subject to an inflation adjustment. The rate is 35 percent for all taxable transfers under the three tax systems. These changes are subject to the sunset provisions of the law which would return the exemption amounts to \$1 million and reinstate the marginal rates up to 55 percent (with a 60 percent surcharge rate in some events) in 2013. Let's look at the most significant planning aspects of the new law moving forward.

***Reunification of the Estate and Gift Tax Exclusions.*** Although the increase of the estate tax exclusion is significant, the increase in the gift tax exclusion is five-fold. This is a tremendous opportunity (which might only have a two-year shelf life) to make lifetime wealth transfers to family members. This could be a particularly important tool for the senior generation owners of a closely held business. In the past, the annual exclusion (currently \$13,000 per donee) and the \$1 million exemption amount limited significant lifetime transfers. This necessitated transfers over a long time horizon and some aggressive value-discounting techniques. For example, the use of family limited partnerships (FLPs), grantor-retained annuity trusts (GRATs), and sales to intentionally defective trusts were employed for large discounted wealth transfers and for life insurance purchases.

The \$5 million gift tax exclusion could simplify the process of transferring the family business and reduce the tax audit risk of employing aggressive techniques. This is particularly true for families where the total wealth does not exceed \$5 million (\$10 million for a married couple). For larger estates, the more aggressive techniques will still be employed but the \$5 million gift tax exclusion provides an opportunity for greater lifetime wealth shifting that can be amplified with successful discounting techniques. The \$5 million exclusion amount can also be used to shelter transfers to an irrevocable life insurance trust (ILIT) for premium amounts that exceed the annual gift tax exclusions available to the grantor of the trust.

***The Portability of the Exclusion Amount Between Spouses.*** Another unique aspect of the new estate tax rules is the ability to "inherit" the unused exemption amount from a deceased spouse. The term "Deceased Spousal Unused Exclusion Amount (DSUEA)" was coined in IRC Sec. 2010(c)(4). The portability of the exclusion amount applies to gift and estate transfers but does not apply to the GST.

*Example:* Mr. A dies in 2011 leaving some of his estate to Mrs. A, but leaves \$2 million to his children from a prior marriage. Since his taxable estate is \$2 million after the federal estate tax marital deduction, his \$5 million exclusion amount goes unused to the extent of \$3 million. Mrs. A now has \$8 million of exclusion amount to be used against her lifetime taxable gifts and/or her taxable estate at the time of her death.

The initial reaction to the portability provision is that most sophisticated planning will be unnecessary for a married couple if their combined wealth is below \$10 million. However, this could be a costly mistake, even if this provision is not allowed to expire after 2012. The estate-planning considerations for adapting to the portability of the exclusion amount include:

- The exclusion amount is transferable to a surviving spouse only if the deceased spouse's executor files a timely federal estate tax return to indicate the amount of exclusion that remains unused. It might be unwise to avoid the trouble and expense of filing this return for a couple without significant wealth since the receipt of an unexpected windfall could place the surviving spouse above a single exclusion amount.
- The use of the traditional marital deduction and credit shelter (exemption/exclusion) trusts may seem unnecessary but would still be indicated in many circumstances. In a high net worth estate, the use of the exclusion trust funded with \$5 million at the death of the first spouse creates an estate freeze since the exclusion amount would be applied to the value of the assets at the time of the first death and subsequent appreciation would escape tax later. The use of the \$5 million exemption at the time of the first death would be particularly beneficial if Congress decides later to allow these provisions to lapse and the exclusion goes back to a lesser amount.
- The use of trusts is necessary for many estates irrespective of the estate tax. An appropriately designed trust provides asset protection for the beneficiaries and, perhaps, the grantor of the trust. If asset protection is a concern or beneficiaries have disabilities or other limitations, a trust is essential. The form of trusts created as part of the estate plan should be determined in conjunction with the wealth transfer tax implications.
- Estate taxes and estate liquidity problems remain a concern for many individuals and families. Life insurance benefits are often indicated to solve or mitigate these problems. In many instances, the irrevocable life insurance trust (ILIT) is the best solution for these circumstances and to provide for subsequent generation beneficiaries. Life insurance may already be in place in the estate plan to preserve assets for the family. This significant change in the federal wealth transfer tax laws indicates a reevaluation of many estate plans. Existing life insurance coverage may have significant value as an asset class, particularly if the health circumstances have changed since the policy was acquired. Prudent decisions should be made with respect to life insurance and adapting existing coverage to the changed circumstances of the wealth transfer taxes.

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This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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