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TO: CLIENTS AND THEIR ADVISORS

RE: ESTATE PLANNING

The Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010 (the "Act"), enacted on December 17, 2010, significantly impacting estate planning issues for 2010 through 2012, which will only be available until December 31, 2012 unless Congress extends these provisions.

SUMMARY OF THE ACT:

- The estate, gift and generation skipping transfer ("GST") tax exemptions have been increased to $5 million per individual (indexed for inflation after 2011), a potential exemption of $10 million for married couples as a result of the new portability provisions, as discussed below.
- The top estate, gift and GST tax rates have been reduced from 45% (which were scheduled to increase to 55%) to 35%.
- Individuals can gift up to $5 million during their lifetimes without paying any federal gift tax.
- Estates of decedents dying in 2010 may choose between:
  - i) no federal estate tax but accepting a modified carryover basis for the estate assets; or
  - ii) being subject to estate tax but receiving a full step up in basis for the estate assets.
- The various "9 month" rules for 2010 decedents are extended to September 19, 2011.
- Estates are still permitted a deduction for estate taxes paid to the individual states.
- Expanded definition of an "interest in a closely held business" for installment payments.

Utilization of $5 Million Exemption and 35% tax rate. Effective January 1, 2013, unless these provisions are modified or extended, the exemption amount will decrease to $1 million ($1.3 million for GST purposes) and the tax rate will increase to 55%. Accordingly, individuals are encouraged to utilize the increased exemption and lower tax rates during this two year window period to make lifetime gifts and consider generation skipping tax opportunities. As a result of the increased exemption, individuals must review the formula clauses in their wills and other planning scenarios to insure that their intended beneficiaries are receiving the full amounts desired. For example, if a By-Pass Trust is funded to the maximum for the benefit of non-spouse beneficiaries, the surviving spouse may not receive as much as intended or if a GST trust is funded to the maximum for direct skip beneficiaries, i.e., grandchildren, the decedent's children may not receive as much as intended. Up to $5 million of the GST exemption may be allocated to a trust created or funded during 2010. Direct skip gifts to beneficiaries were not subject to generation skipping taxes in 2010. A new method of accounting will be used to determine the use of the exemption amount for taxable gifts made prior to 2010. The rate of tax in effect for the year of the new gift will be used in lieu of the rate of tax in effect at the time of the pre 2010 gifts to determine the amount of the exemption amount used by the pre 2010 gifts.

<u>Decedents Dying in 2010</u>. Estates can opt for no estate tax for 2010 and receive the modified carryover basis rules that were set to apply for 2010. These rules permit the adjusted cost basis of the assets in the hands of the decedent to be increased by $1.3 million with an additional $3 million being allocated to assets received by the surviving spouse up to the fair market value at death. This option will generally be elected by large estates to avoid paying a substantial estate tax, effectively trading the estate tax rate for capital gains tax rates in the future. Alternatively, the estate can be subject to estate tax with the $5 million exemption level, maximum estate tax rate of 35% and a step-up in basis for its assets to the fair market value as of the date of death. The executor should make this decision based upon the choice which will produce the lowest combined estate and income tax to be incurred by the estate and its beneficiaries based upon the application of the modified carryover basis rules. This decision should weigh the size and nature of assets owned by the decedent, whether the beneficiaries plan to retain the assets for a long period of time or until death, depreciation recapture applicable to real estate, various income tax rates depending upon the character of the asset sold, income tax deferral techniques and the marginal income tax brackets of each beneficiary. Form 8939 is to be utilized to indicate the new modified carryover basis attributed to the decedent's assets. The decision is also impacted by the imposition of state estate taxes. New York only provides a $1 million exemption.

For decedents dying in 2010 prior to the enactment of the Act, the nine month period for filing an estate tax return, making any payment of estate tax or the disclaiming of an interest in property passing as a result of death is September 19, 2011. This "extension" does not apply for New York estate tax purposes.

<u>Deceased Spousal Unused Exclusion Amount ("DSUEA")</u>. If the estate of a spouse dying in 2011 or 2012 does not utilize its exclusion amount in full the surviving spouse may add the DSUEA to his or her own available exclusion amount for taxable transfers made during life or at death. An irrevocable election and computation must be made by the deceased spouse's executor on a timely filed (including extensions) Form 706, US Estate Tax Return, regardless of whether the estate tax return was otherwise required to be filed. The IRS retains the right to examine the computation of the DSUEA even if the statute of limitations has otherwise expired for the deceased spouse's Form 706. If a spouse is predeceased by more than one spouse the DSUEA is

limited to the unused exclusion of the last deceased spouse. The DSUEA does not apply to the GST exemption of the deceased spouse.

Continued Advantages of Use of By-Pass Trust. With the introduction of the portability of the DSUEA, it may appear that the division of assets between the spouses and the use of a "By-Pass" trust is no longer necessary, but there are still reasons to do so: (i) appreciation of the assets in the By-Pass trust are not subject to estate tax; (ii) creditor protection; (iii) protects against the DSUEA being lost on the death of the second remarried spouse; (iv) the DSUEA is not indexed for inflation; (v) assets can be sprinkled among the surviving spouse or other beneficiaries who may be in a lower marginal income tax bracket; (vi) protects assets for children of the marriage; (vii) useful for GST planning; and (viii) portability is scheduled to expire after 2012.

Planning Opportunities to Leverage the Extra $4, Million Exemption Increase. It may be a limited opportunity to make substantial gifts, of up to $10 million for married couples, to multi-generational trusts, without the imposition of any estate, gift or GST (assuming the allocation of the GST exemption) tax at the time of transfer and on the future appreciation of the gifted assets. Individuals should consider sophisticated planning techniques including, intentionally defective grantor trusts ("IDGT"), irrevocable life insurance trusts ("ILIT") and incomplete gifts to non-grantor trusts. Additionally, the Act did not address the prohibition on short term (less than 10 years) or "zeroed-out" GRATs as well as the application of valuation discounts to non-operating family entities, which should still be considered with other estate planning opportunities. The "sale" of a minority interest in closely-held assets to a IDGT with the application of a significant valuation discount is a very attractive estate planning technique.

Implications on New York State Estate Tax. Due to the disparity between New York's exemption of $1 million and the federal exemption of $5 million, a state estate tax will be triggered for non-marital dispositions in excess of $1 million. A NY estate tax of $391,600 will be owing by the funding of a "By-Pass/Credit Shelter" trust with $5 million. New York has enacted its own "QTIP" law that provides for a state only election to avoid the imposition of the state estate tax upon the first death. This election can only be available if the surviving spouse is the sole beneficiary of the "By-Pass" trust and receives all of the income annually. Alternatively, a supplemental QTIPable marital trust can be funded with the remaining $4 million of the exemption, which would not be qualified for the federal marital deduction but can be qualified for the New York only QTIP election. Wills should be revisited to determine whether to automatically fund these trusts with $5 million or to consider discretionary alternatives such as "Renunciation Trusts" or post mortem discretionary elections by executors. Taxpayers must be aware that although there is no gift tax in New York, lifetime taxable gifts are added back to a decedent's taxable estate and can trigger a New York estate tax even though there is no federal estate tax due.

Our office is available to assist you or your clients in exploring these and other sophisticated gift and estate tax planning opportunities including family limited partnerships, qualified personal residence trusts and charitable scenarios which will assist in the preservation of wealth for future generations. Our other areas of specialization include real estate, tax dispute resolution, business and employment law representation and retirement planning issues.