



# Trusts & Estates Client Alert

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## ESTATE PLANNING UNDER THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010 AND THE OBAMA ADMINISTRATION'S FISCAL YEAR 2012 REVENUE PROPOSALS

### *How the Estate, Gift and Generation Skipping Transfer Tax Provisions have Changed*

As a follow up to our December 20, 2010 Client Alert, in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Act"), Congress made the following changes to the Federal estate, gift and generation-skipping transfer ("GST") tax provisions, effective January 1, 2011 through December 31, 2012:

- **Estate Tax:** The estate tax rate is reduced to 35%, while the estate tax applicable exclusion amount is increased to \$5 million (reduced by the amount of any lifetime taxable gifts made), indexed for inflation in 2012.
- **Gift Tax:** The gift tax rate is also reduced to 35% and, for the first time, the gift tax applicable exclusion amount is increased to \$5 million (or \$10 million for married couples), indexed for inflation in 2012.
- **GST Tax:** For transfers to grandchildren and more remote descendants (or unrelated individuals assigned to those generations with respect to a donor), the GST tax rate is similarly reduced to 35%. The GST tax exemption amount is also increased to \$5 million, indexed for inflation in 2012.
- **Portable Exemption:** Estates may elect to allow the decedent's surviving spouse to "inherit" any of the decedent's unused estate tax applicable exclusion amount. For example, if a decedent has only used \$2 million of his or her \$5 million estate tax applicable exclusion amount, the remaining \$3 million may be used by the surviving spouse.

Commencing January 1, 2013, unless Congress acts, the estate, gift and GST tax provisions that existed before 2002 will be reinstated. At the end of this Client Alert, we have included a chart that sets forth the new rates and exemptions for 2011, 2012 and 2013 and thereafter.<sup>1</sup>

<sup>1</sup> On February 14, 2011, the Obama Administration's Fiscal Year 2012 Revenue Proposals were released. Under these Proposals, the Administration seeks to make permanent the estate, gift and GST rates and exemptions in effect in 2009 – that is, the \$3.5 million estate tax exemption, the \$1 million gift tax exemption, the \$3.5 million GST tax exemption and a maximum estate, gift and GST tax rate of 45%.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Trusts and Estates Group, whose names and contact information are provided herein.

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February 25, 2011

### **Estate Planning Review Recommended**

As a result of the changes in estate, gift and GST tax law, we recommend that your estate plan be reviewed to assess the potential implications of the new law and to determine whether any changes should be made. For example, issues to be addressed include:

- Whether, as a result of the increased Federal estate tax applicable exclusion amount, you would like to adjust the amount passing on your death to your children or your exemption trust for your spouse and/or children. For example, some estate planning documents contain a formula bequest of the Federal estate tax applicable exclusion amount to a trust for spouse and children. Given the increased Federal applicable exclusion amount, this will generate a state estate tax in a state such as New York that has an estate tax and has not similarly raised its applicable exclusion amount. Retaining the formula may be appropriate but we recommend that the issue be discussed.
- Whether, to take advantage of the \$5 million exemption from GST tax, you would like to provide for your grandchildren and more remote descendants on your death.
- Whether your and your spouse's estate plans are appropriately structured to take advantage of the increased estate tax applicable exclusion amount and the GST exemption.
- The implications of "portability" of the estate tax applicable exclusion amount.

### **Estate Planning Opportunities**

Because the recent changes to the estate, gift and GST tax law are only in effect until December 31, 2012, we would recommend that you discuss with us ways in which you can take advantage of various estate planning opportunities, including:

- Making gifts to, or creating trusts for, descendants or others to take advantage of the \$5 million exemption from gift and GST tax, and
- Leveraging the increased exemption amounts through sales of assets to trusts for descendants or others.

Although the 2010 Act made significant changes to the estate, gift and GST taxes, the Act did not modify provisions relating to grantor retained annuity trusts ("GRATs") or discounts for transfers of interests in family-owned entities, which remain effective estate planning strategies. However, the Obama Administration's Fiscal Year 2012 Revenue Proposals ("Obama's 2012 Proposals"), which were released on February 14, 2011, do seek to modify provisions related to GRATs, valuation discounts on family-owned entities and long-term descendants' trusts. In large part, Obama's 2012 Proposals would be effective as of the date of enactment.

In our prior Client Alerts, we noted that the Obama administration and various bills introduced in Congress sought to change the requirements for GRATs, including by: (1) requiring a minimum term of ten (10) years; (2) prohibiting decreasing annuity payments during the first ten (10) years of a GRAT; and (3) requiring that the value of the remainder interest of a GRAT at the time assets are transferred to the GRAT be greater than zero. A GRAT can be an efficient technique to transfer wealth without gift tax, as long as the donor survives the trust term and the trust assets appreciate in value in excess of IRS interest rate assumptions. A shorter trust term can be preferable for planning purposes because it reduces the risk

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February 25, 2011

of the donor's death during the trust term. Conversely, mandating a longer trust term may increase the risk and reduce the effectiveness of using a GRAT in some (but not all) situations. Although the requirements relating to minimum terms, decreasing annuities and remainders greater than zero were not part of the 2010 Act and, therefore, GRATs currently remain effective estate planning strategies, Obama's 2012 Proposals seek to have the changes described above enacted.

Also, the Obama administration and several bills introduced in Congress sought to eliminate the "discounts" available on transfers of interests in family-controlled entities, such as family limited partnerships and family limited liability companies, by requiring that certain restrictions be disregarded when valuing interests in such entities. Currently, section 2704(b) of the Internal Revenue Code provides that certain restrictions may be disregarded unless they are (i) commercially reasonable and arise as part of any financing with non-family members or (ii) imposed by Federal or State law. The Obama Administration seeks to strengthen section 2704(b) by modifying it to create a new class of "disregarded restrictions," including (i) limitations on a holder's right to liquidate the holder's interest in the family-controlled entity (if such limitations are more restrictive than a standard to be set forth in the Treasury Regulations), (ii) restrictions on the ability of a transferee to be admitted as a full partner or holder of an equity interest in the entity and (iii) the ability of certain parties (e.g., charities) to remove restrictions. While these changes were not part of the 2010 Act and, therefore, planning with family controlled entities currently can be an effective wealth transfer strategy, Obama's 2012 Proposals seek to have the changes described above enacted.

An important new change sought under Obama's 2012 Proposals would limit to ninety (90) years the period during which a trust can remain GST tax exempt. Currently, if a donor allocates his or her GST tax exemption (currently \$5 million) to all gifts to a trust, then no matter how much the trust appreciates in value over time, the trust always remains GST tax-exempt. Thus, after the initial gifts to the trust, the trust is not subject to any gift, estate, or GST tax as the trust benefits children, grandchildren and more remote descendants of the donor. If the trust assets are distributed to a beneficiary, however, then the assets will be taxable in that beneficiary's estate. In order to take maximum advantage of the GST tax-exempt nature of such trusts, such trusts are usually structured to be able to last for the maximum period allowed under State law (and are often referred to as "dynasty trusts"). In New York, the period is measured by lives in being at the creation of the trust (that is, a class of people selected by the donor who are alive at the time the trust is created, such as the donor's descendants) plus twenty-one years. In other states such as Delaware, New Jersey or Alaska, a trust can last in perpetuity. By limiting the GST tax-exempt nature of a trust to ninety (90) years, Obama's 2012 Proposals would significantly reduce the long-term benefits of dynasty trusts. This proposal would be effective for trusts created after the date of enactment or to the extent of additions made to trusts created before the date of enactment.

February, 2011

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February 25, 2011

The Estate, Gift and GST tax rates and exemptions for 2011, 2012 and 2013 forward:

	2011	2012	2013 and thereafter <sup>2</sup>
<b>Estate Tax Rate</b>	35%	35%	55%
<b>Estate Tax Exemption</b>	\$5 million	\$5 million (increased by a cost of living adjustment, with base year 2010)	\$1 million
<b>Gift Tax Rate</b>	35%	35%	55%
<b>Gift Tax Exemption</b>	\$5 million	\$5 million (increased by a cost of living adjustment, with base year 2010)	\$1 million
<b>GST Tax Rate</b>	35%	35%	55%
<b>GST Tax Exemption</b>	\$5 million	\$5 million (increased by a cost of living adjustment, with base year 2010)	\$1 million (increased by a cost of living adjustment, with base year 1997)

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<sup>2</sup> These provisions will apply if Congress does not act to undo the "sunsetting" of the Act after 2012.

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## Statement About Circular 230

Recent amendments to a Treasury Department regulation, known as Circular 230, require lawyers and accountants to follow strict rules in issuing a written statement about a Federal tax issue. The most onerous rules of compliance under §10.35 of the Circular involve written advice about so-called Listed Transactions, arrangements that have tax avoidance as their principal purpose and what are called Marketed Opinions. We do not believe any issue discussed in this memorandum relates to a Listed Transaction. We believe the tax benefit sought is consistent with the Internal Revenue Code of 1986 as amended (Code) and Congressional purpose. That means the principal purpose is not tax avoidance. We also believe no issue discussed herein is a significant Federal tax issue – meaning that we believe the IRS does not have a reasonable basis for a successful challenge on the overall Federal tax treatment of the issues discussed in this memorandum. That means we do not think this memorandum must comply with §10.35 of the Circular. Nevertheless, we add the following statements to ensure compliance with said §10.35. Notwithstanding these statements, we believe the conclusions reached herein are correct.

1. The written advice contained in this memorandum is not intended or written by us to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties.
2. No one may use any part of this memorandum in promoting, marketing or recommending an arrangement relating to any Federal tax issue to any taxpayer.
3. Nothing herein shall be construed to impose a limitation on disclosure by any person of the tax treatment or tax structure of any transaction that is addressed herein.

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