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Frequently Asked Questions about the Tax Relief Act 2010

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On December 17, 2010, President Obama signed the “Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010” (“Tax Relief Act” or the “Act”). This article focuses on the part of the bill that applies to the estate, gift and generation skipping transfer taxes for 2011 and 2012 and answers some frequently asked questions. In addition, some estate planning strategies and tax savings strategies are described.

How much can I leave to my beneficiaries without paying tax?

Under the Tax Relief Act, the exemption from estate, gift and generation-skipping transfer (“GST”) tax in 2011 and 2012 is set at \$5,000,000, the highest amount of exemption in history.

What is the new tax rate?

The top rate of tax for estate, gift and GST transfers is now 35%.

How do the new exemption amount and tax rate differ from the old law?

Under the prior tax legislation, the gift tax exemption was \$1,000,000. For estates of decedents in 2009 the federal estate tax exemption was \$3,500,000. The tax rates were higher, with the top rate of tax being 55%.

What are the considerations for 2010?

For 2010, retroactively, the estate of a decedent is subject to the estate tax and the assets includable in the gross estate will be entitled to a “step up” in basis to their date of death values. An executor also has the option to elect out of the estate tax and apply carryover basis, increasing the basis in assets by \$1,300,000, with an additional \$3,000,000 available to allocate to assets passing to a surviving spouse. The gift tax exemption is still \$1,000,000. There is no GST tax on 2010 GST transfers but per the Act, up to \$5,000,000 in GST exemption can be allocated to assets ultimately passing to “skip persons.”

Now that the estate tax exemption has been increased should I make gifts?

Yes. The increased gift tax exemption amount presents an unparalleled opportunity for people to make large gifts to benefit their loved ones, potentially benefit multiple generations, and move value out of their estates. We strongly recommend that people who can afford to make large gifts take advantage of this \$5,000,000 exemption from both gift and GST Tax, as it could be reduced by legislation in future years. Simply put, use it before you lose it.

What are some recommended gifting techniques?

A person who will have a taxable estate notwithstanding the increased exemption might use a grantor trust. If “Edward,” who has total assets of about \$7,000,000, sets up a grantor trust, he can continue to pay income taxes on the income earned on the trust assets using assets outside of the trust. The trust assets can then grow free of having to make income tax payments on the appreciated value. Moreover, by paying the income taxes on the assets in the trust, Edward further reduces the size of his own taxable estate.

One should also consider funding an irrevocable life insurance trust (or “ILIT”) with cash, which cash is then applied by the ILIT to purchase guaranteed (permanent) life insurance. A great deal of insurance can be purchased with sizable gifts and the death benefits remain outside the donor’s estate. For example, “Larry” and “Ida,” a couple in their mid-70s, using just \$1 million of their federal gift tax exemption (\$500,000 apiece) could use an ILIT to acquire a policy with about a \$5 million dollar death benefit. That \$5,000,000 death benefit will not be includable in either Larry or Ida’s estate.

What is “Portable Exemption”?

Under the Act, the executor of an estate in which the decedent is survived by a spouse can transfer the first decedent’s remaining estate tax exemption to the surviving spouse. If a husband dies in 2011 and has used \$1,000,000 of his exemption on lifetime gifts and \$1,000,000 on bequests from his estate to his children, the executor of his estate can elect to transfer his remaining \$3,000,000 exemption to his wife (giving her a total of \$8,000,000 in federal exemption). The transferred exemption may be utilized by a surviving spouse for either federal gift or estate tax purposes.

How do you transfer exemption?

The executor of a deceased person’s estate makes the election on a timely-filed estate tax return. Even the executor of a nontaxable estate where there is a surviving spouse should consider filing a return to elect to transfer the exemption to the surviving spouse.

Are there any limitations to the portable exemption?

Only the last spouse's unused exemption can be used for estate tax purposes. If "Peter" dies and \$3,000,000 of his remaining exemption is transferred to his wife, "Wendy," then she remarries and her second husband, "Paul," predeceases her with only \$1,000,000 of exemption remaining, her estate can use only Paul's \$1,000,000 of spousal exemption. The \$3,000,000 in exemption from Peter is effectively lost. This limitation does not apply for gift tax purposes. In the above scenario Wendy could use Peter's exemption on lifetime gifts to their children and at her death, the exemption from Paul could still be applied to estate devises.

There is also a privity requirement to portable exemption. A surviving spouse cannot use his or her spouse's "deceased spousal unused exemption amount." This means that if Peter's exemption is transferred to Wendy, and she then marries Paul and then dies, her spousal exemption from Peter cannot be transferred to Paul.

Do I still need a trust?

Yes. Traditionally, married people have saved on estate taxes in their combined estates through exemption amount/marital deduction planning using trusts. The planning is done using revocable trusts created by them during life that implement the planning in the wake of the first decedent's death. The first decedent's available exemption amount is held in the trust in such a way that it is sheltered from estate tax in both estates. Property in excess of the exempt amount is typically held for the sole benefit of the survivor and is eligible for the marital deduction from estate tax. Separate elections can be made for Massachusetts and federal purposes. No estate tax will be due from the first estate. At the survivor's death, the only property from the first estate that will be includable in the survivor's taxable estate is the marital deduction property. The exempt/sheltered property remains sheltered. The exempt/sheltered property in the first estate can continue to grow free of estate tax in the survivor's survivorship years. All of the appreciation is sheltered. This is opposed to a transferred exemption amount, where the exemption amount transferred from one spouse to another remains static.

The following examples compare the estate tax ramifications of a transfer of portable exemption from one spouse to another and exemption amount planning for the couple.

Portable Exemption Transfer from "Ruth" to "Hank"

- In 2011 Ruth dies with a taxable estate of \$5,000,000. Her estate plan consists of a will leaving all of her assets outright to her husband, Hank. The executor of Ruth's estate makes the election to transfer \$3,000,000 in exemption (all that remains available to the estate after lifetime gifts to their children) to Hank. No estate tax is due from Ruth's estate.
- A few years later, Hank dies with a taxable estate of \$12,000,000. Hank's estate consists of \$6,000,000 of his own property, plus the original \$5,000,000 he received from Ruth that, happily, appreciated by \$1,000,000 during his life. At the time of Hank's death the exemption is still \$5,000,000 per person with the 35% tax rate. Federally, \$8,000,000 of

his estate is covered by the federal exemption: applying his own exemption and Ruth's \$3,000,000 in exemption. Tax consequences for Hank's estate: the estate will owe Massachusetts estate tax on the full \$12,000,000 and federal estate tax for the \$4,000,000 portion not covered by exemption. Using the Massachusetts estate tax tables, the tax liability is \$1,386,800 to Massachusetts. The amount of federal estate tax due is \$914,620, a figure reached by deducting the Massachusetts estate tax from the gross estate, then subtracting the \$8,000,000 exemption and applying the 35% tax rate.

Exemption Amount Planning for Ruth and Hank with Trusts

- Ruth and Hank's estate planning attorney instead creates exemption amount planning trusts. At Ruth's death, her \$3,000,000 in exemption is allocated to property set aside in the trust that will not be includable in Hank's estate. Ruth's trust also includes Massachusetts estate tax planning to shelter her \$1,000,000 exemption (the balance of \$4,000,000 would be elected as Massachusetts QTIP property). No estate tax would be due from Ruth's estate at her death.
- At Hank's death, the only property in his estate subject to federal estate tax is the \$2,000,000 in marital property that passed to him from Ruth and his own \$6,000,000 in assets. For Massachusetts purposes, he would have a \$10,000,000 taxable estate consisting of his own \$6,000,000 and the \$4,000,000 of Massachusetts QTIP elected property.
- Hank's estate would owe Massachusetts estate tax in the amount of \$1,067,600 and federal estate tax in the amount of \$676,340, a figure reached by deducting the Massachusetts estate tax from his federal gross estate of \$8,000,000, then subtracting his \$5,000,000 in exemption and applying the 35% tax rate.
- Using trusts saved Ruth and Hank about \$557,480 in total estate tax paid. Additionally, all the appreciation earned on the assets from Ruth's estate during Hank's survivorship years escaped taxation in his estate.

An additional selling point for a trust is that a decedent's exemption from GST tax is not portable. Thus, to maximize GST planning couples should establish trusts to which GST exemption can be allocated at the time of the first death. Finally, in addition to the tax incentives behind creating trusts, there are myriad non-tax purposes for setting up a trust (as discussed in our prior newsletter entitled "**An Introduction to Trusts**").

We hope that this discussion of the Tax Relief Act of 2010 is helpful as you review your current estate plan and explore new planning opportunities with your Welch & Forbes portfolio manager.

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