The WEALTH DESIGN Center, LLC

Federal Transfer Tax Chaos – Congress Passes Temporary Legislation

On December 17, 2010 President Obama signed the "Tax Relief, Unemployment Insurance Reauthorization & Jobs Creation Act of 2010" (hereinafter called "TRA 2010"). This legislation has the result of temporarily extending the "Bush tax cuts" which generally featured reduced federal income and transfer taxes. Unless further extended by later legislation, the provisions in TRA 2010 will expire on December 31, 2012. The Act's provisions are quite broad. This communication will summarize only the provisions of TRA 2010 pertaining to federal estate, gift and generation skipping transfer taxes.

NEW RULES FOR ESTATES OF 2010 DECEDENTS

The estates of people who died in 2010 were not subject to the federal estate or generation skipping transfer (GST) taxes because of unique tax rules in place for 2010. These unique rules did not permit assets in those estates to receive a step up in basis for income tax purposes. Instead the basis of estate assets was to be determined under a modified carryover basis system. In many cases, beneficiaries receiving assets from these estates may have preferred to receive a step up in basis, even if it meant possibly paying federal estate taxes. TRA 2010 reinstates the federal estate tax for estates of decedents who died in 2010 but it also permits the executors of those estates to elect between two alternatives:

1. No estate tax but the modified carryover basis tax regime for estate assets (in essence, the pre-TRA 2010 tax result), or
2. An estate tax based on a 35% maximum rate and a $5,000,000 exclusion with a stepped up basis for estate assets to date of death value.

The ability to choose between these alternatives should be a real potential advantage for estate beneficiaries, especially beneficiaries of estates where the taxable estate was less than $5,000,000. Beneficiaries of these estates may possibly get the best of both worlds—a step up in basis on the assets they receive and no federal estate tax.

Even though there was neither a GST tax nor a GST exemption on generation skipping transfers in 2010, there were still some potential problems for GST transfers. TRA 2010 contains provisions designed to eliminate or reduce those problems. The Act creates a $5,000,000 GST exemption for GST transfers in 2010 and establishes a GST tax rate of zero percent for 2010. This gave taxpayers the opportunity to make direct skip gifts during the remainder of 2010 without triggering a GST tax (although a gift tax may still be due).

FEDERAL ESTATE AND GENERATION SKIPPING TRANSFER (GST) TAXES ON PEOPLE WHO DIE IN 2011 OR 2012

TRA 2010 has a number of taxpayer-friendly provisions which are likely to reduce both the

number of estates which will be subject to federal estate taxes in 2011 and 2012 and the amount of federal estate taxes that taxable estates must pay. Some of these provisions include:

- Setting the maximum federal estate tax and GST tax rates at 35%.
- Replacing the modified carryover basis rule of 2010 with the "step up" basis rule of 2009 and previous years.
- Establishing a federal estate tax exclusion amount at $5,000,000.
- Indexing the federal estate tax exclusion amount for inflation in years after 2011.
- Setting the GST tax exemption at $5,000,000.
- Re-unifying the federal estate and gift taxes at a $5,000,000 property amount.
- Adopting the concept of "portability" of estate tax unified credits between spouses (a surviving spouse may elect to take advantage of the unused portion of the estate tax exclusion of a predeceased spouse thereby potentially allowing a surviving spouse to have an estate tax exclusion amount in excess of $5,000,000).

In a number of respects these provisions go far beyond extending the Bush-era federal estate tax rules. Although the TRA 2010 rules are temporary, they have the potential to reduce the number of estates that will be subject to the tax and should significantly reduce the federal estate taxes payable by those estates still large enough to be subject to it.

The 35% maximum rate is considerably less than the 45% maximum rate in 2009 and the 55% maximum rate that would have been in place had TRA 2010 not become law. *The Wall Street Journal* (December 17, 2010) reported an estimate by The Tax Policy Center that the new provisions will cut by at least a third the number of estates subject to the tax (about 5,500 estates paid federal estate taxes in 2009).

The adoption of an exclusion amount of $5,000,000 per person significantly increases the amount of property which can potentially be passed estate tax free to younger generations. Married couples may structure their individual exclusions to pass on a total of up to $10,000,000 estate tax free to their children.

The increase in the GST tax exemption to $5,000,000 per person gives married couples the ability to pass up to $10,000,000 GST tax free down to their grandchildren and younger generations by using generation skipping trusts and "dynasty" trusts.

The new "portability" provision may reduce some of the complexity and inconvenience married couples have experienced in their wealth transfer planning. The new portability rule doesn't require full use of the $5,000,000 exclusion at the first spouse's death.

Since the unused portion of a deceased spouse's exclusion may be passed on to the surviving spouse, there may not be a need to divide assets so that each spouse owns enough property to qualify for the credit. The ability of the surviving spouse to take advantage of the unused portion of the credit may obviate the need to re-title family assets and reduce the use of "credit shelter" trusts.

Because TRA 2010 is temporary, both spouses will have to die before 2013 in order to take advantage of it.

Federal Gift Taxes on Lifetime Transfers Made in 2011 and 2012

TRA 2010 also has a number of taxpayer-friendly provisions pertaining to federal gift taxes on lifetime transfers. Some of these provisions include:

- Retaining the maximum gift tax rate at 35%− it was scheduled to become 55% in 2011.
- Increasing the gift tax exclusion to $5,000,000 per person; the exclusion is to be adjusted for inflation in 2012—in 2009 and 2010 the exclusion was only $1,000,000 per person.
- Re-unifying the gift tax and estate tax. Prior to 2001 the federal estate and gift taxes were "unified." That means that transfers of wealth had essentially the same transfer tax results regardless of whether they were made during life or at death. These taxes shared a single graduated rate schedule which was applied to both lifetime gifts and transfers after death. TRA 2010 re-unifies the gift and estate taxes at a 35% maximum rate through 2012.
- Gifts that qualify as generation skipping transfers may potentially avoid GST tax through a timely allocation of the $5,000,000 GST exemption—in 2009 the GST exemption was $3,500,000 and it was scheduled to be $1,000,000 in 2011.

In a number of respects these provisions go far beyond extending the Bush-era federal estate tax rules.

General Observations

The adoption of TRA 2010 continues the uncertainty around estate and wealth transfer planning. Since its provisions expire on December 31, 2012, the Act does nothing to create a reliable and predictable platform for transfer tax planning. Unless a new law is enacted before December 31, 2012, clients dying after 2012 will be subject to an exclusion of $1,000,000 per person and a maximum tax rate of 55%. The lifetime gifting exclusion and GST tax exemption will also return to $1,000,000. TRA 2010 sets the stage for wealth transfer taxes to be an important issue in the 2012 election.

Thus, as attractive as some of its provisions are, it is important for clients to understand that TRA 2010 is TEMPORARY. Many clients may want to believe that the temporary $5,000,000 exclusion and 35% maximum tax rate is going to become permanent. Although this is possible, it is far from certain. Probably the most valuable benefit of TRA 2010 to financial professionals is that it creates an immediate opportunity to contact clients and set up meetings early in 2011. Producers who study the Act should be able to explain its provisions and start discussions on how clients may use some of these temporary provisions to their advantage. Of course, they should also be advised to consult with their tax and legal advisors before taking action.

Potential Impact on Life Insurance

The temporary increase in the personal exclusion to $5,000,000 may lead some clients to believe they may not need life insurance for estate tax liquidity. However, they must understand that they must die before 2013 to take advantage of the $5,000,000 exclusion. For life insurance underwriting

purposes, the ING Life Companies views TRA 2010 to be of temporary duration. Therefore it is not changing its financial underwriting standards.

Still, the hope that the provisions of TRA 2010 could eventually become permanent may give clients a reason to postpone their estate liquidity planning. For these clients, flexible planning and/or convertible term insurance may give them a relatively low-cost hedge against the possibility that the transfer tax provisions of TRA 2010 do not become permanent. Some of the important life insurance sales opportunities include:

1. Irrevocable Life Insurance Trusts (ILITs)
The increase in the limits on lifetime gifting creates important opportunities for paying life insurance premiums. The increase in the exclusion from $1,000,000 to $5,000,000 is effective on January 1, 2011 and creates immediate funding opportunities for new and existing ILITs. For married couples, the lifetime transfer opportunity increases from a combined $2,000,000 figure to $10,000,000. Depending on the terms of the trust, using the increase in the exclusion may potentially help clients avoid problems that can come from using the $13,000 annual gift tax exclusion (Crummey withdrawal powers) to fund the trust.

2. GST & Dynasty Trusts
These increased gifting limits may be combined with the increase in the GST exclusion to $5,000,000 and thereby create new funding opportunities for generation skipping and dynasty trusts. Clients who are interested in moving some family assets out of the federal estate tax regime for several generations should consider these trusts and may use life insurance on their lives as a trust asset.

3. Personally Owned Life Insurance
Single and married clients with estates under the $5,000,000 and $10,000,000 limits may see an opportunity to increase the wealth they pass on to their children and grandchildren federal estate tax free. They may decide to purchase life insurance equal to the difference between their net worths and the exclusion amount. They could potentially own these policies personally and not trigger estate taxes. Personal ownership would give them maximum control and not require gifts of cash to pay premiums.

4. The Standby Trust Strategy
Married clients could use the Standby Trust Strategy to purchase and pay for life insurance. In this strategy the spouse most likely to die first purchases a second-to-die life insurance policy insuring both spouses. This spouse owns the policy and pays the premiums. At his/her death the policy becomes an asset in the deceased spouse's credit shelter trust. Only the cash value of the policy is included in his/her taxable estate. At the surviving spouse's death, the policy death benefits are paid to the trust and then distributed according to its terms.

5. Premium Financed Life Insurance
Clients who have existing premium finance life insurance arrangements may decide to use part of their increased exclusion to transfer assets to the ILIT so it can repay the funds it has borrowed from commercial lenders. Clients considering new premium finance arrangements have the potential to contribute more funds to the ILIT gift tax free and thus may potentially reduce the amount that is borrowed from outside lenders to pay the policy premium.

6. Existing Private Split Dollar and Private Loan Arrangements
Clients who have advanced funds for life insurance premiums to their children or to ILITs for their benefit, may have an opportunity to reduce the amount to be paid back to them or to "roll out" of the arrangement completely. The increase in the lifetime gifting limit to $5,000,000 for 2011 and 2012 gives them the option to potentially forgive some or all of the repayment they are entitled to receive under the arrangement without triggering federal gift taxes. Forgiving the repayment of a private loan or a private split dollar advance could be attractive because it does not require the transfer any additional cash or property. It also has the advantage of reducing or eliminating the impact of economic benefit reporting (private split dollar) and interest consequences (private loans).

CONCLUSION

TRA 2010 continues the uncertainty that surrounds wealth transfer planning. Its provisions are temporary and expire at the end of 2012. The changes it creates in lifetime gifting limits, although temporary, do create immediate wealth transfer opportunities for clients who have the ability and desire to take advantage of them. These gifting opportunities include a number of valuable life insurance strategies which may help them in efficiently passing on their wealth to their children and grandchildren.

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