

2010 TAX ACT
FREQUENTLY ASKED QUESTIONS
AND ANSWERS
RELATING TO ESTATE PLANNING

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1. WHAT CHANGES WERE MADE TO THE FEDERAL ESTATE TAX EXEMPTION?

Under prior law, the exemption from federal estate tax gradually increased from \$1,000,000 in 2002 to \$3,500,000 in 2009, with a complete repeal of the federal estate tax in 2010. Had there been no legislative action in 2010, the federal estate tax would have returned in 2011 with an exemption of \$1,000,000 and a maximum rate of 55%.

The “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Action of 2010” (the “2010 Tax Act”) reinstated the federal estate tax with a \$5,000,000 exemption effective retroactive to January 1, 2010 and a maximum rate of 35%. The \$5,000,000 applicable exemption will remain in effect until December 31, 2012, with a cost of living adjustment for 2012. The lower \$1,000,000 exemption amount and the higher tax rates will be restored in 2013, unless Congress acts in the interim.

As a result of the 2010 Tax Act, exemption levels for the years 2008 through 2013 are as follows:

2008	2,000,000
2009	3,500,000
2010	5,000,000
2011	5,000,000
2012	5,000,000
2013	1,000,000

There is a special election available to estates of persons who died in 2010 prior to the effective date of the 2010 Tax Act. In such case, the individual’s estate can elect an unlimited estate tax exemption with a carry-over of the decedent’s income tax basis (instead of a step-up in the tax basis of inherited assets which was applicable under the prior law). The step-up in tax basis is applicable to estates of persons who die in 2011 or 2012, or die in 2010 without the special election.

Planning.

We can’t speculate on the political situation in the future. Accordingly, we must anticipate that the \$1,000,000 exemption could return and plan for that possibility. It should be noted that the alternate proposal in Congress was a \$3,500,000 federal estate tax exemption with a 45% maximum rate. There is no assurance regarding future exemptions or rates should a new law be enacted.

For individuals and married couples who expect to be at or near the exemption level, they may want to continue tax-free gifts of \$13,000 per year to individuals. There is a separate New Jersey estate tax issue which has to be addressed (see Question #4 below), and gifting may be helpful in that context. For individuals who have an existing irrevocable life insurance trust (“ILIT”), or are considering acquisition of life insurance, ILITs are still a viable planning device.

Couples should consider retention of formula clauses in their documents, so they do not have to make further modifications, since it is generally anticipated that Congress will do something (See Question #5).

2. WILL MY HUSBAND AND I EACH HAVE A \$5,000,000 EXEMPTION?

A major addition made available in the 2010 Tax Act is a concept commonly known as “portability.” Under prior law, each spouse had an applicable exemption amount (e.g. \$3,500,000 in 2009). However, to the extent that it was not used on the death of the first spouse, the exemption was lost.

Example: Assume H, a married individual, died in 2008 when the applicable exemption was \$2,000,000. Assume further that H and W had assets of \$2,500,000, all of which were held in joint names. At H’s passing, there would have been no federal estate tax because of the unlimited marital deduction. However, H’s applicable exemption was unused and did not carryover to W. If W had passed away when the exemption was still the same with a similar amount of assets, she would have had a taxable estate of \$500,000 (\$2,500,000 - 2,000,000), which would have been subject to federal estate tax at an approximate rate of 45%.

Portability now provides that if the estate of one spouse who dies in 2011 or 2012 does not use the entire applicable exemption, the unused portion is available to the surviving spouse. In order to obtain the use of portability, a federal estate tax return must be filed by the estate of the deceased spouse, and the executor must make an election to allow the surviving spouse to use the unused amount.

Example: H dies in 2011 with \$1,000,000 of assets in his individual name and \$1,500,000 in joint property. H is survived by W. Assume that under the formula clause in H’s Will/Trust, the assets in his individual name are allocated to a credit shelter residuary trust. Therefore, H only used \$1,000,000 of his \$5,000,000 exemption. In order to pass H’s unused applicable exemption of \$4,000,000 to W, the executor of H’s estate

must file a federal estate tax return. W and her estate will have an available exemption of \$9,000,000 (her \$5,000,000 plus \$4,000,000 from H). The result might be different if W remarries. Of course, this example assumes the portability provisions in the 2010 Tax Act do not change.

Planning.

We don't know if portability will continue after 2012. A surviving spouse may remarry, which may cause the survivor to lose the exemption carryover.

- Widows and widowers should be careful about plans to remarry.
- Couples should continue the formula clauses or incorporate a disclaimer trust in their documents. (See Question #5)
- The use of a credit shelter trust assures that the applicable exemption will not be lost and that the trust property will eventually pass to intended remainder beneficiaries.

3. ARE THERE ANY CHANGES TO THE GIFT TAX?

Prior to 2011, for lifetime gifts, the exemption was limited to \$1,000,000 even though the exemption for an estate was a higher amount. The 2010 Tax Act increased the gift tax exemption to \$5,000,000 for gifts made after 2010. As such, the exemption has been "reunified" for gifts made in 2011 or 2012. If a non-taxable gift of \$3,000,000 is made in 2011, and Congress changes the law to provide an estate tax exemption of only \$2,500,000 on the donor's subsequent death after 2012, the excess over \$2,500,000 would become taxable in his or her estate if the new law does not "grandfather" such prior gifts.

Example: An individual made a gift in 2009 of \$3,500,000. Because the gift exemption in 2009 was only \$1,000,000, the excess of \$2,500,000 was subject to the gift tax in 2009. However, a similar gift of \$3,500,000 made in 2011 would not be subject to gift tax since the applicable exemption for gifts in 2011 and 2012 is the same as the exemption for estates (i.e. \$5,000,000).

Planning.

- People who previously used their \$1,000,000 lifetime exemption can now make additional transfers up to \$4,000,000. Gifts transfer assets at today's values so that an

opportunity is created for real estate which is currently depressed. Future income and appreciation (hopefully) on such gifts will not be included in the donor's estate. This is particularly advantageous for gifts of stock of close corporations, LLC interests, and assets anticipated to appreciate in value and for which current discounts are available.

4. HOW DO THE CHANGES IMPACT ESTATE TAXATION IN NEW JERSEY?

The New Jersey inheritance tax exempts transfers to spouses (or civil union partners), children (or descendants) and to parents (or other ancestors). Property passing to siblings and others is subject to an inheritance tax at rates varying from 11% to 15%.

Separate and distinct from the inheritance tax is the New Jersey "estate tax." This was previously known as the "sponge" or "pickup" tax because it was based on the tax credit available under federal estate taxation for state death tax payments.

The New Jersey estate tax exemption is \$675,000, the amount that was exempt under the federal estate tax in 2001 before the federal tax law changed. New Jersey "decoupled" its estate tax and a separate calculation is required. Accordingly, many estates that are not subject to federal estate tax will incur a New Jersey estate tax liability.

Example: W, a single individual, dies in 2011 with an estate of \$1,000,000 which she leaves to her children. There would be no federal estate tax, since her estate is under the \$5,000,000 exemption. Also, there would be no New Jersey inheritance tax because W's estate is left to her children. However, New Jersey requires that we compute the New Jersey estate tax as if W had died in 2001 when the federal estate tax exemption was \$675,000. We have to determine the amount of state death tax credit that would have been due to New Jersey in 2001. In such case, the estate tax payable to New Jersey would be \$33,200. We are required to prepare and file a *pro forma* federal estate tax return showing the 2001 computation.

Current amounts of the New Jersey Estate Tax are illustrated as follows:

<u>Taxable Estate</u>	<u>New Jersey Estate Tax Payable</u>
\$ 675,000	0
\$1,000,000	\$ 33,200

\$1,500,000	\$ 64,400
\$2,000,000	\$ 99,600
\$3,500,000	\$229,000

In his budget submitted in February 2011, Governor Christie proposed increasing the New Jersey exemption to \$1,000,000.

Pennsylvania has not “decoupled” its estate tax similar to New Jersey. However, the Pennsylvania inheritance tax applies at a rate of 4 ½% on property left to parents, children and grandchildren.

Planning.

For individuals with estates at or near the New Jersey credit amount, documents should include a credit shelter trust or disclaimer trust which will utilize the exemption available. By so doing, both spouses will have a \$675,000 exemption, or a couple will be entitled to a \$1,350,000 total exemption between them. Since New Jersey does not provide for portability, the failure to have a credit shelter trust may result in higher taxes when both estates are considered.

Some states (primarily Florida) do not impose an inheritance or estate tax. If individuals can satisfy the factual criteria to establish residency, a change in domicile should be considered.

5. DO MY EXISTING DOCUMENTS HAVE TO BE REVISED?

Without regard to taxes, you should take this opportunity to review your documents to determine whether any non-tax events require that provisions be modified. Changes in family situations that may impact on the need to re-evaluate your planning include:

- Birth of a child or grandchild
- Death or divorce of a spouse
- Marriage or divorce of a child
- Change in asset values
- Ability of persons named to serve as fiduciaries or guardians
- Second marriage
- Need for a living will and/or power of attorney
- Civil union legislation

Prior estate planning for married couples utilized a “credit shelter” or a “residuary trust” formula clause to take advantage of each spouse’s applicable exemption, since “portability” was not then available.

The formula clause frequently provides a marital gift or qualified marital trust equal to the amount by which the decedent’s estate exceeds the applicable exemption for federal estate tax purposes. With the increase in the exemption to \$5,000,000, even without portability, most couples will not exceed the exemption (assuming it stays the same).

Example 1. H and W have assets of \$2,500,000, all of which are in W’s name. Assume that her documents provide a marital gift to H equal to the amount by which W’s estate exceeds the federal estate tax applicable exemption. If W predeceases H, under her existing documents, her entire estate would pass to the credit shelter trust and nothing would pass directly to H other than joint assets or non-probate assets where H is named as a beneficiary, such as an IRA or 401(k) Plan. Couples may not like this result and may want all or part of an estate to pass to the surviving spouse. Also, since W’s estate is over \$675,000, there could be a New Jersey estate tax. The executor of W’s estate could make a qualified terminal interest property (“QTIP”) election for the portion above \$675,000 to avoid immediate taxation in New Jersey.

Example 2. H and W with combined assets of \$2,500,000 have simple Wills leaving everything to each other. If one of them died there would be no federal or New Jersey estate tax because of the marital deduction. On the death of the survivor, however, estate taxes are uncertain. Depending upon the applicable exemption in 2013 and thereafter, there is no assurance that their plan will be carried out, or what federal estate tax, if any, will be due. They would lose the use of the deceased spouse’s \$675,000 New Jersey exemption.

6. IS GENERATION-SKIPPING TRUST (“GST”) PLANNING STILL AVAILABLE?

Yes. A GST allows property to be held for a child during such child’s lifetime and pass to grandchildren free of estate tax in the child’s estate. An important advantage of a GST is a non-tax concern. The GST assures that the trust assets are held for the child’s use and are generally free of claims of his or her creditors (including a spouse in a matrimonial matter). It assures that the GST funds are available for grandchildren’s education.

The GST exemption is the same as the federal estate tax exemption, i.e. \$5,000,000 through the end of 2012.

7. IS THERE ANYTHING ELSE THAT IS NEW IN THE 2010 TAX ACT?

As a matter of fact, consideration should be given to items that were not included in the legislation.

Prior estate planning techniques included use of discounts in valuing gifts of stock in closely held companies and LLC interests. These discounts were available for minority interests and for lack of liquidity and marketability. Legislation had been introduced that would have limited this planning opportunity. There was nothing in the 2010 Tax Act that changed the prior favorable rules on discounts. This is clearly good news, and a reason to consider gifting during this window of opportunity.

Further, a frequently used planning device is a grantor retained annuity trust ("GRAT"). The 2010 Tax Act did not limit the use of a GRAT, although there had been proposals to eliminate this planning opportunity.

Summary

The changes resulting from the 2010 Tax Act and anticipated future legislation, along with the applicability of the decoupled New Jersey Estate Tax, impact most estate plans. We invite you to contact our office to schedule an appointment to re-examine your estate plan, to review tax considerations, and assure the planning meets your current objectives.