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New Tax Law Provides Some Welcome But Temporary Answers

After a year fraught with questions from anxious professionals and clients alike about a multitude of estate planning and estate administration issues, Congress provided many answers in the form of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act"). The Act addressed many of the questions that had been plaguing tax planning discussions for over a year, and provided some welcome relief from the uncertainty that haunted 2010 discussions, albeit temporarily. Many of you had discussions with us concerning whether gifting patterns should change for 2010 – either be escalated, halted or otherwise recharacterized, to accommodate the puzzling landscape. Clients who came in to revise estate planning documents found additional language in their trusts designed to insure flexibility in view of the complete lack of certainty about the future of the controlling estate tax regime. We appreciate your patience and good humor, which made our professional lives more pleasant in this time of uncertainty. We now have – for two years – some clearer answers to these questions, and they do present some opportunities, particularly for clients of substantial wealth who are inclined to make transfers of significant amounts during their lifetimes. The Act expires by its own terms at the end of 2012, and without permanent (or further extending) legislation we will again find ourselves facing lower exemptions, higher rates and more uncertainty. We should, however, proceed with what we know is pertinent at this time and help anyone who wishes to utilize the techniques that present themselves as good planning opportunities.

Changes in the Estate Tax Regime

The Act increases the federal exemption amount; reduces the top estate tax rate; and introduces the concept of "exemption portability" (see box below). The federal exemption amount – the amount that each individual may shelter from federal estate tax – has been increased to $5,000,000 for estates of individuals dying in 2010, 2011 and 2012 (please see the box on page 3 for more details on 2010 estates). Thus there is no federal estate tax on the estates of decedents whose estates (when added to taxable lifetime gifts) are less than $5,000,000. With proper planning, married couples may pass on up to $10,000,000 without federal tax if they die while the provisions of the Act control. In addition, the estate tax rate has been reduced to a flat 35%, and estates may still deduct various items, including any state death taxes paid. These changes were remarkable for their generosity, falling just short of the goals of proponents of full repeal of the estate tax, and as a result, very few estates will be subject to the federal estate tax during this time period.

The changes described above are all federal changes, and as of this writing the Maine estate tax remains unchanged, with a tax on estates over $1,000,000, a special marital election that is limited to $2,500,000, and no portability. Historically, Maine allowed a separate state-specific QTIP election for an amount equal to the difference between the federal exemption amount and the Maine exemption amount. In an effort to work around Congressional inaction (and the reality that for most of 2010 there was **no federal exemption amount** because there was no federal estate tax), Maine law was amended in late 2009 to cap Maine QTIP trusts at the difference between the federal exemption amount and the Maine exemption amount **in effect in 2009.** Because the federal exemption amount in 2009 was $3,500,000 and the Maine exemption amount was $1,000,000, Maine QTIP trusts are now capped at $2,500,000. However, now that Congress has increased the federal exemption amount to $5,000,000, Maine couples can no longer shelter the full spread (now $4,000,000) with a Maine QTIP – leaving a question about what is best done with the excess $1,500,000. There is a bill in the legislature that would remove the reference to 2009 law and, therefore, remove the $2,500,000 cap and make it possible to take advantage of a larger Maine-specific marital election and postpone the payment of Maine estate tax until the death of the survivor. In addition, the Governor's biennial budget included an increase in the Maine exemption amount to $2,000,000 effective January 1, 2013. We will continue to watch as potential changes to Maine law make their way through the legislature, and will keep you informed of significant developments. Unless the state law has some minor modifications made to accommodate some of the surprises under the new federal law, estate planning for couples who are Maine residents will remain intricate and rely on elections that balance saving potential future federal estate taxes against paying some Maine estate tax on the first estate.

Portability – Ephemeral Gimmick or Panacea?

The Act introduced a new concept available to married couples, which permits a surviving spouse to use the unused federal estate and gift tax exemption of a deceased spouse to shelter additional assets from transfer tax; this concept is known as "portability." The concept may be best illustrated by John and Mary, a married couple, each of whom leaves $1,000,000 in trust for their children in their estate plans and leaves the balance to the survivor. Let's assume their estates take full advantage of portability, make the proper elections, and all of this happens under the two-year window (we know, that is a lot to assume, which is why portability is unreliable for the near future). Under portability, upon John's death, his estate would use only $1,000,000 of his $5,000,000 exemption to fund the trust for his children, and if Mary dies not having remarried, Mary would have her own $5,000,000 exemption plus John's $4,000,000 unused exemption; allowing Mary to leave up to **$9,000,000** to her children with no federal taxes. John's estate need not have had assets that equaled the full $5,000,000 to allow Mary to utilize his full unused exemption. However, a decedent is limited to the unused exemption of his or her most recent deceased spouse; so if Mary married again and that spouse predeceased her, Mary would be able to use that subsequent spouse's unused exemption, not John's. It is important to understand that portability relates to federal estate and gift taxes and not to state estate taxes or federal generation skipping planning. Thus each spouse's plan must make independent plans for state estate tax planning and generation skipping planning. Portability, if made permanent, may change the face of many estate plans for couples of moderate wealth, but at this point, in view of the two-year nature of the Act, portability should not be relied upon, and traditional estate planning trust techniques should remain in estate plans as a general rule (at least until the fate of portability becomes clearer). Even if portability becomes permanent, trusts will still likely have an important role in planning for most couples who are Maine residents.

Dramatic Change in the Gift Tax Structure

One of the most significant surprises in the Act was the reunification of the exemption of the federal estate and gift taxes for 2011 and 2012. The Act increased the exemption amount for gifts to $5,000,000 and matched the gift tax rate with the federal estate tax rate at 35% for these two years. Gifts made in 2010 were subject to the old rules of a $1,000,000 exemption and what we thought was a temporarily reduced top rate of 35%. The gift tax exemptions can be increased to absorb the unused exemption of a predeceased spouse if proper elections are made under the portability concept. The gift tax exemption will actually be indexed for inflation in 2012. Individuals who had previously made taxable gifts using some or all of their previous $1,000,000 exemption can now make additional gifts of $4,000,000 or more without payment of additional tax (total tax free transfers may rise to the level of $5,000,000). For example, let's say John has made taxable gifts of $1,500,000 during his lifetime; the first $1,000,000 was free of tax and the last $500,000 incurred a tax ($210,000) which John has paid. John can now make gifts of up to $4,000,000 in addition, without paying additional gift tax.

Maine continues to have no gift tax, and gifts made more than one year prior to death are not taxed in the calculation used in the majority of our client's estates (taxable gifts determine if an estate must file a return but only enter into an isolated category of calculation of the Maine estate tax under an alternative tax calculation for estates just over the $1,000,000 threshold). Thus, wealthy clients who choose to make large taxable gifts under the new federal law may actually significantly reduce the Maine estate tax on their estates.

GST Changes Include Helpful Technical Provisions

The federal exemption from generation skipping taxes has also increased to $5,000,000, and thus individuals who wish to establish generation skipping trusts or make gifts or testamentary transfers to grandchildren or other beneficiaries in that generational assignment may plan on the higher exemption at least for the next two years. The generation skipping exemption is not portable between spouses, so individuals who wish to make certain that they establish the maximum exempt level of GST transfers will need to create separate trusts that utilize each spouse's $5,000,000 exemption. The Act also addressed a myriad of questions raised by the peculiar posture of the law in 2010 before the passage of the Act to confirm the safety of many well-established estate planning techniques (those of you who have had an issue with this in 2010 will likely remember the daunting conversation and our fretful concerns). Unfortunately, these provisions are also set to expire in 2012 and may raise the same questions all over again concerning new transfers and also concerning the safety of transfers made under certain circumstances since 2001. We can hope that Congress does not intend to leave us with the many technical conundrums created by 2010 law as it pertained to the GST tax, and we will await permanent solutions in 2011 or 2012.

The Act is Only Temporary

All future planning should be mindful that the Act expires by its own terms at the close of 2012, at which time we would return to the old law, with federal estate and gift tax exemptions of $1,000,000 and top rates as high as 55% (plus a surcharge for the largest estates). Thus, unless Congress takes action to provide a more permanent solution, the year 2012 promises to share some unfortunate similarities with the waning of 2009, when clients and practitioners were left to wonder what the future would hold. The year 2012 is a presidential election year, and a question for pause is whether that backdrop will confound Congress more than the political climate of 2009/2010 and result in another stalemate. It is very important to keep this in mind when we consider the importance of the Act and its provisions, for the resolutions will all be on the table for discussion again in two years; we have eliminated our office betting pool on what Congress will do. It is possible that all of the provisions of the Act will become permanent; it is possible that some will become permanent; and it is possible that none will become permanent. Our crystal balls are now completely clouded and we are resigned to simply watch, and plan very carefully and cautiously for what awaits us in the unpredictable future. The President's recent budget proposal appears to continue some of the changes but not all of them.

Choices for 2010 Estates

The Act allows the estates of 2010 decedents to make a subtle but important election to choose to be subject to the estate tax regime under the Act (with a $5,000,000 exemption, a 35% rate, and a full step-up in basis for all assets includable in the estate) or to "opt out" and elect to have the law that was in place for most of 2010, known as "carry over basis regime," apply. The carry over basis regime included no federal estate tax but did include a limitation in the increase in cost basis – the estate of a decedent with no surviving spouse is limited to an additional $1,300,000 of increase in cost basis to be allocated among the estate assets. This yields no federal estate tax but might have a dramatic impact on capital gains when the estate beneficiaries liquidate the assets. Under the Act, the default is the **new** regime ($5,000,000 exemption; 35% rate; and full stepped-up basis). For most 2010 estates over $5,000,000 with no surviving spouse, the Personal Representative will simply choose to have carry over basis apply, but the occasional estate just slightly over the threshold but with very low basis assets might make the other choice to pay a nominal estate tax and avoid capital gain on the assets.

How Does This Affect You?

Whenever new federal legislation is passed, the question that arises is what this may mean for clients and their estate planning. Without reviewing each situation individually, it is impossible to provide a detailed answer that is correct for all. It is, however, possible to make some general observations. You should always feel free to call us directly so we can provide an answer that is more tailored to your situation. If it has been a few years since you revisited your estate plan, it would be wise to touch base to make sure you are not completely out of date. Having some general up to date financial information ready for us is always helpful during such a review.

All clients, including those who are single or do not provide for their spouses in their plans, should consider the amount to be held in trust, either generation skipping or long term trusts. Any trusts created by reference to the full federal exemption amount will have increased to the $5,000,000 threshold, at least for the next two years, and that might be more than you wish to have remain in the trust structure. It is possible to cap these trusts to allow a percentage or dollar amount of assets to be held in an ongoing trust that is more comfortable and appropriate for you and your beneficiary; from a beneficiary's standpoint there really is a difference in the flexibility of access to assets owned free of trust and access to assets held in trust.

Married clients who have formulas that rely on the division between family trusts and marital trusts have another level of concern. If the only trust and tax planning documents for a midsize estate keeps the Maine exemption in trust and the balance passes free of trust to the survivor or in one big trust for the survivor, then documents drawn relatively recently likely do not need to be changed. If additional assets are held in a QTIP style marital trust (as is the case for so many of our clients) which is tailored to the Maine marital election, various elections made on an estate tax return should allow the proper result. Those clients should understand that if one of them dies before there is a remedial change made to Maine law (if any), the elections on the deceased spouse's estate tax return may be a bit different than originally anticipated, but the surviving spouse will likely have available, as one choice, the option of deferring all Maine tax until his or her death. Again, this is because current Maine law caps the amount one can put into a Maine QTIP trust at $2,500,000. Trusts that are very out of date and create a Family Trust for the benefit of spouse and others in the amount of the federal exemption will trigger a significant Maine estate tax on the death of the first to die. Flexibility to preserve the various options available at death is the best approach, because it accommodates potential changes in Maine law and changes in the family's financial circumstance.

Many documents drafted recently would set aside a special Maine marital trust that is the difference between the two exemptions (currently $4,000,000); both Maine and federal law would allow for partial elections, and thus the tax planning in these cases is flexible and permits the surviving spouse to have the appropriate choices. Married clients who come in now and need a total revision of their plan for a variety of reasons might see tax planning formulas that are different from plans that we drafted last year, but many plans that were drafted recently will still function just fine because the formula anticipated the need for flexibility.

Perhaps the most significant planning for clients will be for individuals with high net worth who may want to use the increased amount that can be transferred over the next two years to beneficiaries free of gift tax. For those individuals, such transfers are likely to reduce the amount of Maine estate tax that will be due on their death if they survive one year after the transfers, and they can take advantage of many gift planning vehicles that were left intact by the Act, including GRATs and transfers of interests that might be legitimately eligible for discounts due to the nature of what is being transferred. If the exemptions are reduced in the future, there is no guarantee that under future law the gifts made in 2011 and 2012 of up to the full $5,000,000 exemption will not be subject to a "claw back" or subsequent tax, but that seems unlikely. Thus it is possible (but not guaranteed) that individuals who make large transfers within the next two years might be able to transfer assets free of federal transfer taxes that they could not transfer tax free in the future if Congress lowers the exemptions.

We realize this is all complex, confusing, and mixed news. We are grateful for the certainty under the new federal law, but we share your frustration that the relief is temporary. In all events, we will help you make the best of it. Please do not hesitate to call on any of us to discuss planning options and help you achieve the best results for you and your family.