New Law on Federal Estate, Gift and Generation Skipping Transfer Taxes

President Obama has signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("Tax Relief Act"), which impacts estate, gift and generation-skipping transfer taxes and may affect your existing estate plan. The Tax Relief Act also provides unique planning opportunities for 2011 and 2012.

Overview of the Law

The Tax Relief Act increased the available exemption from the federal gift and estate taxes to $5 million, and decreased the marginal gift and estate tax rate to 35%. The Tax Relief Act also increased the exemption from the generation-skipping transfer tax ("GST Tax") to $5 million and decreased the marginal GST Tax rate to 35%.

Gift and Estate Tax Exemptions and Rates. The federal gift tax exemption is the amount in excess of the $13,000 annual exclusion gifts that an individual may transfer during his or her lifetime to anyone other than a spouse who is a U.S. citizen without the imposition of a federal gift tax; the federal estate tax exemption is the amount that you may leave to your beneficiaries, other than a spouse who is a U.S. citizen, upon your death without having to pay any federal estate tax. An individual may transfer an unlimited amount of assets to his or her spouse who is a U.S. citizen during life or upon death without the imposition of a federal gift or estate tax. Prior to the Tax Relief Act, the federal gift tax exemption was $1 million, and the federal estate tax exemption was $3.5 million. The top marginal tax rate was 45% for both the estate and gift tax.

For 2011 and 2012, the Tax Relief Act unifies the federal gift and estate tax exemptions, meaning that individuals now have a single exemption amount that can be used during life and/or upon death to protect transfers of wealth from gift and estate taxes ("Federal Exemption"). The Tax Relief Act increased the Federal Exemption to $5 million per individual and decreased the top marginal estate and gift tax rate to 35%.

Portability of Federal Exemption. For married couples, the Tax Relief Act created the concept of "portability" of a deceased spouse's Federal Exemption. For a married individual who dies in 2011 or 2012, the Tax Relief Act allows the executor of his or her estate to transfer unused Federal Exemption to the surviving spouse, effectively increasing the surviving spouse's Federal Exemption. For example, if a wife dies in 2011 or 2012, is survived by her husband and uses only $2.5 million of her $5 million Federal Exemption, then her surviving husband will have a Federal Exemption of $7.5 million (i.e., his own $5 million Federal Exemption plus his wife's unused Federal Exemption of $2.5 million, which was transferred to him by the executor of his deceased wife's estate). He can use this Federal Exemption to make transfers during his life and upon his death free of federal gift and estate tax if the appropriate election is made.

GST Exemption and Rate. In addition to federal gift and estate taxes, federal law imposes a GST Tax on any assets that are transferred to or for the benefit of individuals who are two or more generations below the transferor, such as a grandchild. Individuals are also

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granted an exemption from the GST Tax ("GST Exemption"). Prior to the Tax Relief Act, the federal GST Exemption was $3.5 million, and the top marginal tax rate was 45%.

For 2011 and 2012, the Tax Relief Act increases the federal GST Exemption to $5 million per individual and decreases the top marginal GST Tax rate to 35%. Unlike the Federal Exemption, the executor of a deceased spouse's estate may not transfer any unused federal GST Exemption to the surviving spouse. Therefore, the GST Exemption is not portable like the Federal Exemption. Married individuals must properly plan to take advantage of each spouse's GST Exemption.

State Laws. Both New York and New Jersey continue to implement state estate taxes. New York currently has a state estate tax exemption of $1 million. New Jersey currently has a state estate tax exemption of $675,000. The marginal rate for each of the New York and New Jersey estate taxes is 16%. Due to the greater disparity between the Federal Exemption of $5 million and the New York and New Jersey state estate tax exemptions, it is important to review your existing estate plan. If the plan maximizes the use of your Federal Exemption, there may be a state estate tax imposed upon your death that could be avoided or deferred. In contrast to the new federal law, the state estate tax exemptions are not "portable" from a deceased spouse's estate to his or her surviving spouse.

Planning Opportunities

The Tax Relief Act has provided individuals with new planning opportunities by increasing the Federal Exemption to $5 million. In addition, by not addressing certain planning techniques, such as valuation discounts and grantor retained annuity trusts ("GRATs"), which proposed prior legislation had sought to eliminate or reduce, the below planning techniques are currently allowed under the Tax Relief Act.

Gifting. The increased Federal Exemption and GST Exemption, combined with lower tax rates, provide tremendous new planning opportunities, particularly for individuals who had already used their $1 million lifetime gift tax exemption. Such individuals now have an additional $4 million of Federal Exemption, which, when coupled with the increased GST Tax Exemption, can be used to transfer substantial wealth to children and grandchildren without any gift or GST Tax. These increased exemption amounts are not permanent, however, as the Tax Relief Act is set to expire December 31, 2012.

Discount Planning. Senior generations often choose to hold family wealth and businesses in corporations, limited liability companies ("LLCs") or family limited partnerships ("FLPs"). When the senior generation transfers minority interests in these closely-held entities to their children or more remote generations, the value of these transfers may be discounted because of their "lack of marketability" and "minority interest" status. Congress considered imposing more stringent requirement on the valuation of LLCs and FLPs, specifically to reduce the availability of such valuation discounts upon the transfer of these entities. However, no such restrictions were included in the final version of the Tax Relief Act. As such, LLCs and FLPs remain viable entities through which to hold and transfer wealth at reduced tax values. The transfer of interests in LLCs and FLPs often occurs via transfers to intentionally defective grantor trusts ("IDGTs") or GRATs set up for the benefit of children and more remote generations.

Transfers to IDGTs. An IDGT is a special type of trust whereby an individual's transfers to the trust are recognized for estate and gift tax purposes but not income tax purposes. As such, the individual can transfer assets out of his or her estate without any income tax

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consequences (i.e., gain recognition on a sale to the trust). Sales to an IDGT are commonly referred to as a "freezing technique," as the individual freezes the value includable in his or her estate at the sales price of an asset and pushes all appreciation on that sold asset into the IDGT. Often, sales to an IDGT are made in exchange for a promissory note, which the IDGT can pay off over time with the income generated from the asset sold to the trust. As discussed above, the sales price of the asset transferred to an IDGT, if held in an LLC or FLP, may be reduced by valuation discounts, furthering the power of this estate planning technique.

Transfers to GRATs. A GRAT is also a special type of trust, sanctioned by the Internal Revenue Code, which also allows individuals to transfer wealth at greatly reduced tax values, thereby preserving the Federal Exemption for further lifetime planning. If the wealth is held in a family business, such as an LLC or FLP, then valuation discounts may apply to further reduce tax values and further preserve the Federal Exemption. For more information on GRAT planning, please read "GRAT-- Act Before It's Too Late."

How to Act

Time is of the essence: Congress is still considering restrictive legislation in the area of valuation discounts and GRATs, and the Tax Relief Act is scheduled to expire on December 31, 2012—so you should review your estate plan now to take advantage of these changes in the law. To discuss the opportunities presented by the Tax Relief Act, please contact:

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