

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010



On December 17, 2010 President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"). The Act significantly changes the federal estate tax, which impacts estate planning for many of our clients, and presents significant estate planning opportunities. This memorandum summarizes the Act's key changes and provides you with our observations about the Act's impact from an estate planning perspective. Please note that there are several important changes made by the Act that this memorandum does not summarize.

SUMMARY OF KEY ESTATE AND GIFT TAX PROVISIONS OF THE ACT

Estate Tax

Before the Act, the federal estate tax was gradually reduced over several years and then eliminated for decedents dying in 2010. Prior law provided that the estate tax, with a maximum tax rate of 55 percent and a \$1 million applicable exclusion amount, would be reinstated after 2010. Additional changes scheduled for years after 2010 affected the gift and generation-skipping transfer ("GST") taxes.

The Act reinstates the estate tax for decedents dying during 2010, but at a significantly higher applicable exclusion amount of \$5 million, and a lower maximum tax rate of 35 percent, than under prior law. This estate tax regime continues for decedents dying in 2011 and 2012. Unfortunately, this new regime is itself temporary and will sunset on December 31, 2012 and the prior estate tax regime, with a 55 percent maximum estate tax rate and a \$1 million applicable exclusion amount, is reinstated at that time.

The Act also eliminates the modified carryover basis rules for 2010 and replaces them with the stepped-up basis rules that had applied before 2010. Property with a stepped-up basis generally receives a basis equal to the property's fair market value on the date of the decedent's death. Under the modified carryover basis rules that applied during 2010 before the Act, executors could increase the basis of estate property only by a total of \$1.3 million (plus an additional \$3 million for assets passing to a surviving spouse, for a total increase of \$4.3 million), with other estate property taking a carryover basis equal to the lesser of the decedent's basis or the property's fair market value on the decedent's death.

The Act gives estates of decedents dying during 2010 the option to apply (1) the estate tax based on the new 35 percent top rate and \$5 million applicable exclusion amount, with stepped-up basis, or (2) no estate tax and modified carryover basis rules under prior law.

The Act also provides for "portability" between spouses of the estate tax applicable exclusion amount for estates of decedents dying in 2011 and 2012 if both spouses die before 2013. Generally, portability allows surviving spouses to elect to take advantage of the unused portion of the estate tax applicable exclusion amount (but not any unused GST tax exemption) of their predeceased spouses, thereby providing surviving spouses with a larger exclusion amount. Special limits apply to decedents with multiple predeceased spouses.

To preserve the first deceased spouse's unused applicable exclusion amount, the executor for such spouse must file an estate tax return and

make an election on such return, even if such an estate tax return would otherwise not be required.

Gift Taxes

For gifts made in 2010, the maximum gift tax rate is 35 percent and the applicable exclusion amount is \$1 million. For gifts made in 2011 and 2012, the Act limits the maximum gift tax rate to 35 percent and increases the applicable exclusion amount to \$5 million. As discussed below, this change provides an opportunity to move significant amounts of wealth free of estate and gift taxes.

Donors continue to be able to use the annual gift tax exclusion before having to use any part of their applicable exclusion amount. For 2010 and 2011, the annual exclusion amount is \$13,000 per donee (married couples may continue to "split" their gift and may make combined gifts of \$26,000 to each donee).

Generation Skipping Transfer ("GST") Tax

The Act provides a \$5 million GST exemption amount for 2010 (equal to the applicable exclusion amount for estate tax purposes) with a GST tax rate of zero percent for 2010. For transfers made after 2010, the GST tax rate would be equal to the highest estate and gift tax rate in effect for the year (35 percent for 2011 and 2012). The Act also extends certain technical provisions under prior law affecting the GST tax.

OBSERVATIONS REGARDING THE ACT

Generally

Generally, the estate and gift tax provisions of the Act are very favorable to taxpayers because of the substantial increase in the applicable exclusion amount, to \$5 million, and the lower maximum estate and gift tax rate of 35 percent. The Act also addresses several technical estate, gift and GST tax issues in a manner that is favorable to taxpayers (e.g., the impact of the lapse of the estate tax, including the application of basis rules, on decedents passing away during 2010).

Temporary Fix

The Act is a temporary fix, which sunsets on December 31, 2012, immediately after the next election cycle. It is impossible to predict whether it will be extended in either its current or some modified form, especially given the fact that it is a hot button issue with both major political parties. If Congress fails to act, the Act will lapse and the estate tax will revert to what it would have been under prior law (i.e., \$1 million applicable exclusion amount and 55 percent maximum estate and gift tax rate).

Increased Gift Tax Applicable Exclusion Amount

From 2001-2010, the applicable exclusion amount for gift tax purposes has been \$1 million. The Act increases this to \$5 million, or \$10 million per married couple. This change provides an unprecedented opportunity to move substantial amounts of wealth out of individuals' estates. There are several techniques that individuals can use to leverage this \$5 million applicable exclusion amount, to move substantially more wealth out of their estates.

To illustrate, individuals can now make gifts of \$5 million to trusts governed by the laws of certain states, such as Delaware and Alaska, move all growth in such wealth out of their estates, provide a significant amount of asset protection for such assets, and the transferor may continue to be a discretionary beneficiary of such trusts, without any gift tax cost.

In addition, the increased gift tax applicable exclusion amount increases the amount of assets that individuals can transfer via an installment sale to a dynasty/grantor trust. Under this estate planning technique, individuals can now make an initial gift of as much as \$5 million (\$10 million per married couple) to a dynasty trust, and then transfer as much as \$45 million (\$90 million for a married couple) to such dynasty trust in exchange for an installment note. This technique works especially well for family businesses that are expected to grow significantly in value over time.

Given the fact that the Act will sunset without further Congressional action in 2012, we are advising clients that it would be prudent to implement estate planning techniques utilizing lifetime gifts before the December 31, 2012 sunset date.

State Estate Taxes

Many states have separate estate tax regimes with lower applicable exclusion amounts than the federal applicable exclusion amount. These include the District of Columbia, Maine, Maryland, Massachusetts, New Jersey, and New York, Rhode Island, Vermont among others. It is critical that the estate plans of individuals living in or owning property located in such states address such estate tax exposure.

Portability

One of the more notable provisions contained within the Act is the "portability" provision, which provides in general terms that if one spouse does not fully utilize his/her entire \$5 million applicable exclusion amount, the unused portion can be used by the surviving spouse's estate. This provision is intended to avoid the need for credit shelter trusts in estate planning documents. Unfortunately, both spouses must die before 2013 in order to benefit from the portability provision.

In addition, credit shelter trusts continue to provide significant additional benefits beyond just the use of each spouse's applicable exclusion amounts. These include the following:

- Ensuring that assets contained in the credit shelter trust pass to children of the couple and not to any new spouse of the surviving spouse.
- Ensuring that appreciation on the assets contained within the credit shelter trust, which may exceed the applicable exclusion amount at the surviving spouse's death, are not subject to estate tax at that time.
- Protection of assets in the credit shelter trust from creditors of the surviving spouse, including any marital claims of future spouses.

Given the fact that the portability provision will sunset in 2012, as well as for the reasons stated above, we are advising clients to continue to use estate plans that incorporate credit shelter trusts.

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Things Not In the Act

There are two key provisions that many commentators feared would be in the Act, but which were not included in it. Specifically, there have been several proposals to place limits on Grantor Retained Annuity Trusts ("GRATs"), which allow individuals to transfer wealth out of their estates with as little as a zero estate or gift tax cost that would have made GRATs less valuable from an estate planning perspective. There have also been several proposals to limit valuation discounts in connection with certain estate planning techniques such as family limited partnerships. There were no such provisions included in the Act. Therefore, these techniques continue to be available to move wealth to lower generations.

Temporary Relief Does Not Extend to Non-US Citizens Who Are Not Resident for Estate Tax Purposes

The Act reinstates federal estate taxes on United States-situs property of non-US citizens who are not residents. The increased applicable exclusion amount to \$5 million per person does not apply to non-US citizens who are not residents. US situs property exceeding \$60,000 in value is again currently subject to US estate taxes beginning at graduated marginal rates beginning at 18 percent. Accordingly, particular vigilance needs to be exercised in structuring the acquisition of US assets such as real property, so as to avoid imposition of US estate taxes at pre-2010 levels.

SUMMARY

To summarize, the Act makes significant estate and gift tax changes. The key points discussed above include the following:

- The estate tax exclusion amount increases to \$5 million per person for 2010 through 2012.
- The maximum estate and gift tax rate is reduced from the 55 percent maximum rate under prior law to a maximum estate and gift tax rate of 35 percent for 2011 and 2012.
- A "portability" provision is included, which allows surviving spouses to use any applicable exclusion amount that is not used by the first spouse to pass away.
- The GST exemption amount is increased to \$5 million for 2010 through 2012.
- The Act sunsets at the end of 2012, thus making the foregoing changes temporary in nature.

As always, we recommend that clients review their estate plans periodically and/or whenever a significant life event occurs (e.g., birth of a child, death of a spouse, purchase of new home, etc.).

Clients with substantial amounts of wealth (and/or with closely held businesses) may want to consider using lifetime gifts to take advantage of the current \$5 million (\$10 million per married couple) lifetime gift tax applicable exclusion amount. As mentioned earlier, absent further Congressional action, this increased exclusion is scheduled to revert to \$1,000,000 at the end of 2012.

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