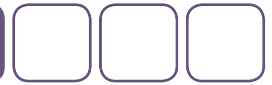

New rules

Jennie Cherry summarises new US estate, gift and generation-skipping transfer tax laws effective 2010-2012

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When the 2010 New Year dawned it was the first year since 1916 that the United States had no estate tax. The gift tax rate last year was 35 per cent with a credit sheltering USD1 million from gift tax. Executors of estates of decedents dying in 2010 could allocate USD1,300,000 to 'step up' the income tax basis of appreciated assets owned by the decedent at death, eliminating some capital gain when later disposed of by the heirs. This was a radical change from the transfer tax laws of 2009 with a top tax rate of 45 per cent, a USD1 million lifetime gift tax exemption, and a credit that sheltered up to USD3.5 million (the 'exclusion amount') from estate tax.

Tax practitioners and family advisors waited all year to see if Congress would extend the 2009 estate and gift tax laws, enact new laws retroactively or take no action and allow the law in 2011 to revert to pre-2001 rules (55 per cent top rate, USD1 million exclusion amount) as it was scheduled to do under existing law. Finally, on 17 December 2010, President Obama signed into law the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (the *Tax Relief Act*) so that as 2011 dawns US citizens and domiciliaries are subject to a new set of tax rules for 2010-2012 and executors of those 2010 estates may choose to opt out of the new 2010 estate tax.

Estate tax

The *Tax Relief Act* has reinstated the estate tax at a maximum rate of 35 per cent for estates of decedents dying after 31 December 2009 and before 1 January 2013, and provides a USD5 million exemption amount. The decedent's assets are 'stepped up' to fair market value as of date of death for income tax purposes. Beginning with estates of decedents dying after 31 December 2010, the *Tax Relief Act* allows the estate of a surviving spouse to utilise the unused exemption amount of the previously deceased spouse. This is often referred to as 'portability' and must be affirmatively elected on the estate tax return of the first spouse to die.

The estate tax is levied on the value of the worldwide estates of US citizens, regardless of their domicile at death, and the estates of individuals domiciled at death in a state within the United States. Estates of decedents who were neither US citizens nor US domiciliaries are subject to estate tax only on US situs assets, also at the top rate of 35 per cent but with a credit that shelters only USD60,000.

For estates of decedents who died in 2010 the executor has a choice. The executor may elect to opt out of the estate tax under the *Tax Relief Act* and instead stick with the rules previously in effect for 2010 so that there would be no estate tax to pay and a modified step up in basis. This decision should be determined on a case-by-case basis. The Internal Revenue Service will need to publish rules and forms to allow an executor to elect out of the estate tax. Estate tax returns for decedents dying in 2010 will be due within nine month of the date of enactment of the *Tax Relief Act*, rather than the usual nine months after date of death.

Gift tax

For gifts made in 2010, the *Tax Relief Act* maintains the top gift tax rate of 35 per cent and an exclusion amount of USD1 million. For gifts made in 2011 and 2012, the gift tax is reunified with the estate tax , meaning that an individual may apply the USD5 million exclusion amount to lifetime gifts so that no gift tax is owed until he or she makes taxable gifts in excess of USD5 million. Any exclusion amount remaining at death will be applied to the estate tax calculation. An individual's exclusion amount is reduced by any exemption amount he or she used before 2011. For example, if an individual makes taxable gifts of USD600,000 in 1997 and USD400,000 in 2010, and then dies in 2012, the exclusion amount available to his or her estate would be USD4 million. Applying portability, if that individual's estate was valued at USD3 million, the executor could elect for the remaining USD1 million exclusion amount to be utilised by the surviving spouse giving him or her an exclusion amount of USD6 million.

Generation-skipping transfer tax

The generation-skipping transfer (GST) tax is complicated and designed to ensure that the transfer of wealth is subject to tax in each generation. If a gift or bequest is made to a grandchild, thereby skipping the generation of the donor's child, a GST tax is levied at the highest estate tax rate on the value of transferred property. The tax also applies to certain trust distributions. The GST tax had been repealed for 2010 transfers along with the estate tax. The *Tax Relief Act* reinstates the GST tax but at a rate of 0 per cent for transfers in 2010. For GST transfers in 2011 and 2012, the GST tax rate is 35 per cent. The GST exemption amount is USD5 million and any unused amount is not portable to a surviving spouse.

After 2012

The provisions of the *Tax Relief Act* are scheduled to 'sunset' at the end of 2012. If no action is taken, the estate, gift and GST tax laws will revert to pre-2001 levels with a top tax rate of 55 per cent and a USD1 million exemption amount applicable to combined lifetime gifts and transfers at death.

GRAT planning still viable

Legislative proposals had required a ten-year minimum term for a grantor retained annuity trust (GRAT). Under a GRAT a donor gifts property to a trust for a specified term of years. During that term the donor is paid a prescribed annuity and at the end of the term the remaining trust corpus is paid to a trust for descendants. If GRAT assets appreciate in value during the term in excess of the annuity, that appreciation passes to the remainder beneficiary. The GRAT is designed so that the value of the remainder interest (using an interest rate set by the Internal Revenue Service) is very close to zero, thereby transferring future appreciation for little or no gift tax (and no estate tax if the donor survives the term). Requiring a ten-year minimum term would have substantially restricted the effectiveness of GRAT planning. The *Tax Relief Act* does not include any provisions dealing with GRATs.

Impact on US tax planning

The *Tax Relief Act* extends the individual income, capital gain and dividend tax rates along with certain credits and deductions. It is worth a closer look for those advising US citizens and residents. Executors of estates of decedents who died in 2010 should analyse whether to opt out of the estate tax. If the estate is in excess of USD5 million, consideration should be given to whether the benefits of the step-up in basis for all appreciated assets are outweighed by the estate tax due.

As for estate tax planning for 2011 and 2012, many married couples should divide their assets so that each holds at least USD5 million. Advisers should continue to recommend that these couples execute wills and trusts with provisions fully utilising their exemption amounts at the time of their respective deaths. This is beneficial even given the new portability rule. A trust in the estate of the first spouse to die, which holds assets equal to that spouse's exemption amount and is not included in the estate of the second spouse to die, shelters those assets – and any appreciation in value between the deaths – from estate tax. Allocating GST exemption to the trust and continuing to hold assets in trust for descendants, further shields appreciation from tax and provides non-tax benefits such as creditor protection. Note that where one spouse is not a US citizen planning is complicated by the fact that an unlimited marital deduction is not available for assets passing outright to the surviving non-citizen spouse.

Gift tax planning is still important and individuals who had fully utilised their previous USD1 million gift tax exclusion amount now have another USD4 million of exemption available. Moreover, gifting strategies such as GRATs should continue to be considered. Again, when planning for couples where one spouse is not a US citizen care must be taken as gifts between spouses could be subject to gift tax.

Conclusion

Tax practitioners and family advisors now have answers and some certainty for the next two years of US tax planning. In addition to reviewing and implementing estate plans and gift strategies, these professionals must council their clients on foreign financial asset reporting obligations also enacted in 2010. There will be additional guidance, rules and regulations from the Internal Revenue Service to contend with. What will the dawn of 2013 hold? Again, we must wait and see what Congress decides, but it is likely that the USD5 million exemption, and even portability, will be reenacted, even if to do so requires rate increases above 35 per cent.