



Estate Planning Update



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

On December __, 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act") to temporarily extend the Bush-era tax cuts for a period of two years through December 31, 2012. President Obama is expected to sign the 2010 Act almost immediately after it is passed by Congress. The following is a summary of the tax provisions in the 2010 Act that are most relevant for individuals in connection with their estate planning.

Estate, Gift and GST Taxes

Background

Prior to enactment of the 2010 Act, the federal estate tax had been subject to a one-year repeal for persons dying in 2010, but it was due to be reinstated in 2011. Also, the federal generation-skipping transfer ("GST") tax was repealed for 2010 but was due to be reinstated in 2011. Although the federal gift tax remained in place for 2010 with a \$1 million gift tax exemption amount per person, the federal gift tax rate was lowered to 35%. One trade-off for not having an estate tax in 2010 was that the assets owned by a person dying in 2010 did not automatically receive a full "stepped-up basis" for income tax purposes; instead, only a limited stepped-up basis was available for the estates of persons dying in 2010. This has been called "modified carryover basis."

If the Bush tax cuts had expired on December 31, 2010 as scheduled, the federal estate and GST taxes would have been reinstated effective January 1, 2011, with a \$1 million gift and estate tax exemption amount per person, and only a slightly higher GST tax exemption amount. In addition, the maximum estate, gift and GST tax rates would have reverted to 55%, effective January 1, 2011. As described below, the 2010 Act has changed these rules.

2010 Act Provisions for Estate, Gift and GST Taxes

The 2010 Act sets each of the gift, estate and GST tax exemption amounts at \$5 million per person (or \$10 million for married couples) for 2011 and 2012. This exemption amount is indexed for inflation beginning in 2012. Further, the 2010 Act creates a flat 35% tax rate in 2011 and 2012 for gift, estate and GST taxes. The 2010 Act also restores the rules regarding a full "stepped-up basis" for income tax purposes for assets owned by a person when he or she dies.

Because the 2010 Act "reunifies" the federal estate and gift tax exemptions for 2011 and 2012 at a \$5 million exemption amount per person, each individual will have the opportunity to use any portion of his or her \$5 million exemption during 2011 and 2012 to make gifts of up to \$5 million (taking into account prior gifts) without paying any gift tax. Married couples can therefore make lifetime gifts of up to \$10 million (taking into

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account prior gifts) without paying any gift tax.

Another very significant provision of the 2010 Act is that for the first time, the estate of a spouse dying in 2011 or 2012 can elect for his or her surviving spouse to utilize the unused part of the deceased spouse's estate tax exemption amount. This is referred to as creating "portability" of estate tax exemption amounts between spouses, and it is an entirely new concept that will make it easier for married couples to obtain the benefit of both of their respective \$5 million exemptions from estate tax.

Special provisions for the year 2010 under the 2010 Act. Although the federal estate tax (with a \$5 million estate tax exemption amount) is technically reinstated retroactively to January 1, 2010, the estate of a person who died in 2010 can elect to have the "no estate tax" provisions of prior law, along with modified carryover basis, apply to that person's estate. For most estates of persons who died in 2010 with assets significantly in excess of \$5 million, this would appear to be the preferable choice to minimize overall taxes.

In addition, the 2010 Act sets the GST tax exemption at \$5 million retroactively to January 1, 2010 and the GST tax rate at zero percent for 2010. The 2010 Act also keeps the gift tax exemption amount at \$1 million and a flat 35% gift tax rate for 2010. For individuals who are in a position to make substantial gifts solely for grandchildren and are willing to pay up to a 35% gift tax, making such a gift for grandchildren before December 31, 2010 could be very attractive, since no GST exemption would need to be used to shield such gift from GST tax.

The provisions of the 2010 Act as described above are only effective through December 31, 2012. Congress will need to act again before then to further extend these estate, gift and GST tax provisions. While it would have been preferable for Congress to enact a more permanent solution to the ongoing uncertainty in this area rather than enacting a two-year temporary fix, the changes of the 2010 Act hopefully represent the basis for a more stable estate, gift and GST tax system in future years.

Estate Planning Recommendations in Response to the 2010 Act

What should individuals do in response to these significant changes in the estate, gift and GST tax law? The following is a summary of some of the initial issues to consider in light of the 2010 Act:

- Current Review of your Will and Estate Plan. The new "portability" of the \$5 million estate tax exemption amount between spouses will mean that the wills of many married couples may need to be modified, and in the case of many clients, wills can be simplified. For the past 30+ years, the wills of many married clients have included tax-planning provisions creating a so-

called "bypass trust" or "family trust" to protect the estate tax exemption of the first spouse to die of a married couple. The combination of the increased \$5 million estate exemption and new "portability" concept may enable many married couples to eliminate such a trust and allow assets to be given directly to the surviving spouse.

Second, most wills and other estate planning documents are designed to minimize estate taxes by having formula provisions that are dependent on the estate tax exemption amount, the GST tax exemption amount, or both. Because of the changes under the 2010 Act, these formula provisions may produce unintended consequences for a person who dies during 2011 or 2012, including the possibility of changing the intended beneficiaries who will receive property under a person's will. For example, assume that a person's will makes a gift equal to "the largest amount that can pass free of federal estate tax" to his or her children, with the remainder of property given to such person's spouse, and that person has less than \$5 million of assets. If this person dies in 2011 or 2012, the children may receive 100% of this person's property and the spouse may receive no property. Other examples would include wills that have similar formula provisions to make charitable gifts or generation-skipping gifts for grandchildren.

We think it is very important that you consider these recent changes in the tax law in connection with your current estate plan and encourage you to review these matters as one of your New Year's Resolutions! At a minimum, you should be aware of the possible impact of the 2010 Act on your estate plan and should consider what changes, if any, should be made to your wills and other estate planning documents.

- Make Gifts for Family Members During 2011 or 2012. For individuals who want to make gifts to family members, gifts can be made in 2011 or 2012 that utilize an individual's \$5 million gift tax exemption amount, or \$10 million gift tax exemption amount per married couple (taking into account prior gifts). Such gifts can be made outright or in trust, and GST exemption can be allocated to a gift to a long-term trust to protect it from future estate and GST taxes.
- Make Proper Elections for Persons Who Died in 2010. The estate of a person who died in 2010 can elect to have no estate tax along with modified carryover basis (essentially, the Bush tax cuts for 2010). For most estates of persons who died in 2010 with assets significantly in excess of \$5 million, this appears to be the right choice to minimize overall taxes. On the other hand, for the estate of a person who died in

2010 with less than \$5 million of assets, it will likely make sense not to make the election, and have the 2010 Act provisions apply. This will result in no estate tax (because of the person's new \$5 million estate tax exemption amount) along with the full stepped-up basis in assets for income tax purposes. However, the new portability rules described above will not apply to any unused exemption amount of a deceased spouse, since the portability rules only apply to individuals dying after December 31, 2010.

- Make Gifts for Grandchildren By December 31, 2010. For individuals who are in a position to make substantial gifts solely for grandchildren and are willing to pay up to a 35% gift tax, making gifts for grandchildren before December 31, 2010 could be very attractive because no GST exemption would need to be used to shield such gift from GST tax. This would allow that person's full \$5 million GST tax exemption (taking into account the prior use of any GST tax exemption) to remain intact to use for future planning opportunities in 2011 and beyond.

Such gifts during 2010 for grandchildren could be made in a trust that includes future, unborn grandchildren as beneficiaries, as long as at least one grandchild is currently living. It should be noted, however, that any later distributions from such a trust for family members in a lower generation (e.g., great-grandchildren) would likely be subject to GST tax at such later time.

Of course, we stand ready to assist you in any way with any of these items. With respect to any gifts for

grandchildren by December 31, 2010 described above, please let us know as soon as possible if you would like to discuss and act on this before year-end.

Income Taxes

The 2010 Act extends current income tax rates, including the 15% federal tax rate on capital gains and qualified dividends, for an additional two years through 2012.

In addition, the 2010 Act reinstates, for each of 2010 and 2011, the ability of individuals over age 70½ to make tax-free distributions of up to \$100,000 directly from their Individual Retirement Accounts (IRAs) to public charities. This was the tax law during 2006 – 2009 but had previously expired for 2010. These direct distributions from an IRA to a public charity can count toward an individual's required minimum distribution (RMD). The 2010 Act also allows individuals to treat any such distributions made in January 2011 as having been made during 2010.

For a description of all of the changes made by the 2010 Tax Act, go to <http://finance.senate.gov>, click on "Legislation," then click on "The Reid-McConnell Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" in the Title column, and then click on "Summary of The Reid-McConnell Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010."

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