Before the Door Closes

With significant tax provisions set to expire at year end, planning now can capture these unique opportunities before they may disappear

by Richard James and Steven Lavner

The temporary tax law changes enacted in 2010 — which include higher exemptions, lower rates, a reunified exemption for gift and estate taxes, and portability of the estate tax exemption — are only in place through 2012, when they are set to expire at the end of the year.

Your U.S. Trust advisor can review your estate plan in light of the expiring tax provisions, identifying potential pitfalls and opportunities over the near term.

The Implications of the Tax Law Changes

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The act made significant (although temporary) changes to transfer tax laws for 2011 and 2012, creating both risks and opportunities for families and individuals with substantial wealth.

Key Changes for 2013

1. The estate and gift tax exemption is $5,120,000 in 2012, but is scheduled to decrease to $1 million in 2013.

2. The generation-skipping transfer (GST) tax exemption is $5,120,000 in 2012, and is scheduled to decrease to approximately $1,390,000 in 2013.

3. The maximum gift, estate and GST tax rates are set at 35% in 2012, and are scheduled to increase to 55% in 2013 (with an additional surtax of 5% on taxable estates between $10,000,000 and $17,184,000).

4. Estate tax exemptions were made portable between spouses. When one spouse dies, at the election of the deceased spouse’s executor, any of the $5,120,000 exemption that is not used can be transferred to the surviving spouse. This “portability” option is set to expire at the end of 2012.

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Of course, scheduled tax law changes are never a certainty if recent history is any guide, and particularly this time around, given the upcoming presidential election. No one knows whether Congress will extend these provisions or change them. Without Congressional action, the higher rates and lower exemptions of nearly a decade ago will return. However, the current administration’s budget proposal calls for a 45% tax rate and a $3.5 million exemption in 2013. It should be noted currently that all Republican presidential candidates have expressed a desire to see the estate tax fully repealed. Given the uncertainty of future changes in the law, taking advantage of current exemptions and maintaining flexibility may be more important than ever.

The fact that the higher exemption amounts discussed may expire at the end of 2012 does not mean that you must take advantage of them now. Rather, we suggest that you consider the possible expiration of these favorable exemptions as one of many factors in your planning process.

Don’t Let These Planning Opportunities Slip Away

By increasing the federal estate tax exemption to $5,120,000, the law vastly reduces the number of estates that are subject to estate tax — and decreases the estate tax burden for others. However, despite this mostly positive impact, there are a number of planning issues to consider, including:

Higher exemptions may affect formula-driven provisions in estate planning documents. Although the higher exemption is set to expire at the end of 2012, it may still make sense to review certain estate planning documents, particularly wills and revocable trusts, in the context of these exemptions. A higher exemption may have a significant impact on commonly employed estate planning techniques, such as the funding of family and marital trusts.

Formula-driven provisions in wills and trusts that were based on lower exemption amounts to determine what portion of the estate would be used to fund a family trust (with the remainder of the estate going to a spouse) could have unintended consequences if the higher exemptions are not considered. Reviewing your will and estate planning documents can help ensure that your estate is allocated tax-efficiently, and as you originally intended, even after the change in the law.
State estate tax exemptions are mostly unchanged. While the federal estate tax exemption has been increased to $5,120,000, exemptions at the state level are typically lower. Your U.S. Trust advisor can suggest gift and estate planning strategies for managing the gap between federal and state tax exemptions.

Take advantage of more generous lifetime giving limits. There are many reasons to consider giving assets away during your lifetime rather than as part of your estate, especially in light of the gift tax exemption’s more than fivefold increase from $1 million to $5,120,000. If you previously used your $1 million exemption in prior years, you may have just the remainder of this year to give away another $4,120,000 without triggering a federal gift tax. As with most tax laws, there are several uncertainties, but one in particular deserves special attention. If the estate exemption at death is less than the gift exemption used during life, there might be a recapture of tax on the difference (sometimes referred to as the “clawback” provision). While Congress could conceivably address this perceived flaw, it is important that you consult with your attorney and other tax advisors to evaluate the potential consequences of such a “clawback.”

Strategies to Consider in the New Environment

The increased exemptions for gift and GST taxes could make a number of lifetime estate planning tools more attractive:

Outright gifts: Such gifts may be made using cash, stock or other property. If there are outstanding family loans, gifts may also be made by forgiving all or part of the loan. There may be an ancillary benefit for making gifts for taxpayers who reside in a state that also imposes a state-level estate tax. Of all the states that impose a state estate tax, only two (Connecticut and Tennessee) also impose a gift tax on lifetime transfers. Thus, for most taxpayers a lifetime gift of the federal exemption can also reduce state estate taxes without any gift tax cost.

Dynasty trusts: Higher exemption amounts allow you to place more of your assets in very long-term trusts that can benefit many generations of your family without being exposed to further estate tax. How long a trust can last is a matter of state law, and only certain states allow trusts to have unlimited duration. Delaware was one of the first and remains a leader. U.S. Trust maintains a trust company in Delaware, and has extensive experience in structuring and administering dynasty trusts. The current administration’s
budget proposals currently call for a 90-year limit on how long such trusts can remain unexposed to estate or GST tax; however, even if these recommendations are enacted, trusts established before the law goes into effect may be grandfathered.

**Spousal trusts:** A number of trust structures allow individuals to transfer assets to their spouses in trust, which allows a certain degree of access to and control of these assets. Your U.S. Trust advisor can discuss with you how to leverage these structures to achieve your estate planning goals.

**Traditional techniques:** It is possible that many of the traditional techniques of planning (e.g., Irrevocable Life Insurance Trust (ILIT), Qualified Personal Residence Trust (QPRT), Sale to a Defective Grantor Trust, etc.) can benefit from and be better used by taking advantage of this temporary increase in the level of gift, estate and GST exemptions. Your U.S. Trust advisor can provide you with materials describing these traditional techniques in more detail and discuss with you how to leverage these techniques with the higher exemptions.

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**If a spouse dies without using his or her full estate tax exemption, the surviving spouse can use the remainder.**

Assume a married couple has combined assets of $10 million, with $3.5 million in the husband’s name and $6.5 million in the wife’s name. The husband dies first, and his entire $3.5 million in assets is left to a family trust. However, with an exemption limit of $5,120,000, there is $1,620,000 in unused exemption. His executor elects to transfer the $1,620,000 to the widow. She then has a total exemption of $6,740,000, which is enough to cover her entire estate and can be used during her lifetime or at death.

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**Consider the Benefits of New Portability Provisions**

Currently, the law allows the unused portion of one spouse’s estate tax exemption to be transferred to the surviving spouse, to be used during the survivor’s lifetime or at death. This is a significant change; before 2011, any unused portion of the exemption was forever lost. Portability expires along with the other tax changes at the end of 2012.

**Remarriage complicates the picture.** Portability applies only to the surviving spouse. If the surviving spouse remarries, he or she might not be able to transfer the first spouse’s unused exemption to the new wife or husband.

**There is no portability for generation-skipping transfers.** Portability applies only to the estate tax exemption, not the GST exemption. If the first spouse to die does not fully use the $5,120,000 GST exemption, any unused portion cannot be transferred to the surviving spouse.
There is no portability of the state estate tax exemption. For those states that impose a state-level estate tax, most have an estate exemption far below the federal exemption of $5,120,000. At present, no state-level estate tax incorporates any similar portability provision. If the state exemption is not taken advantage of at death, its benefit will be forever lost. Thus, relying completely on the federal portability provision may cause you to lose the benefit of your state exemption.

Portability will not take the place of effective estate planning. Portability can be useful in many situations. For instance, portability may be helpful where one spouse owns substantially more assets than the other spouse and where it is not practical or desirable to transfer assets to the other spouse. Additionally, it may be beneficial in estates where the married couple has less than $10,240,000 in total net worth. In larger estates, relying on portability may not be the optimal solution. It’s also important to remember that portability exists only at the federal level, and even for a $10 million estate, GST must be addressed on a non-portable basis. Whether or not portability is advantageous or could be used in your particular situation, you must also consider and plan for the fact that, as the law currently exists, portability will apply only if both spouses die in 2011 or 2012.

The advice and guidance to navigate tax law changes

Through 2012, you will have an opportunity to take advantage of higher gift and GST exemptions and lower tax rates.

U.S. Trust provides the expertise to support your planning, with strong capabilities in trust administration and tax planning. Your U.S. Trust team can provide more detailed information about how your planning strategies can best be adapted for a changing tax environment.
Be Ready to Review Your Plan Again in 2013

Estate and gift tax policy has been in flux for the last several years, surrounding most wealth planning decisions with an unusual degree of uncertainty. Unfortunately, we feel this trend is likely to continue. The current round of tax law changes is scheduled to expire at the end of 2012, possibly creating a new landscape for you.

As a result, it now may be more important than ever to review your estate plan regularly with your advisors. Your U.S. Trust advisor can analyze your estate planning documents and determine whether you should consider potential changes to help maximize your estate planning.

Your U.S. Trust advisor can help you evaluate your estate planning objectives in the context of recent tax law changes and make sound decisions. Talk to your advisor about how current and future changes may affect your particular situation.