

Recent Changes to the Federal Estate and Gift Tax: What Does this Mean to You?

By Kari Brotherton and Nancy Kennedy

As you are already likely aware, there were recent changes to the estate and gift tax laws. However, these changes are only effective in 2011 and 2012. In addition, proposed budgets are being discussed that would change the effective rates and limits after 2012 and may eliminate some popular estate planning tools. So, what does this mean to you? It means that now is the time to review your current estate planning documents, as well as your long- and short-term estate planning goals. Documents might need to be updated. You may want to accelerate gifting plans or start a new one. Or, you may want to implement gifts that have provisions which may be altered or eliminated in the near future. In short, it is time to contact your professional advisors to discuss what they can do to help make sure you have the most effective estate plan for you.

SO, WHAT'S CHANGED? The significant provisions affecting estate and gift taxes that were signed into law on December 17, 2010 as part of a major tax overhaul include the following:

- **Higher estate tax exemption.** Increased from the 2009 \$3.5 million exemption, the 2011 estate tax exemption is \$5 million, which will be indexed for inflation in 2012. Thus, a married couple may transfer up to \$10 million to their heirs, free of federal estate tax. (Note, however, the Washington state exemption has not changed and remains at \$2 million per person).
- **Lower estate tax rate.** Decreased from the 2009 45% flat tax rate, in 2011 and 2012 the federal estate tax rate is 35%. (The Washington State estate tax ranges from 10% to 19% and any state tax paid will reduce the federal taxable estate).
- **Reunification of federal estate and gift taxes.** This means the \$5 million federal estate tax exemption can also be applied toward lifetime gifts. While the gift tax exemption has been \$1 million, it is now \$5 million. In addition, any taxable gift in excess of the exempt amount would be subject to gift tax at the lower 35% flat rate.
- **Generation-skipping transfer tax.** Generation skipping transfer tax ("GSTT") is basically a separate tax on transfers of property to grandchildren and those deemed to be two or more generations below that of the transferor. There is now a 35% flat rate for the GSTT, and a \$5 million GST exemption.
- **Estate tax portability.** A new concept of estate tax exclusion amount called portability was introduced by the recent changes. Portability means to the extent the \$5 million exemption is not used by the estate of the first deceased spouse, the surviving spouse may use the remaining exemption amount along with their own \$5 million exemption. Thus, the federal estate tax exemption is a combined \$10 million for a married couple. (Note, Washington State does not have portability).

The above changes in federal laws are effective only in 2011 and 2012, so we are again in a state of uncertainty as to what happens next. However, recent budget proposals include a reduction in the estate tax exemption back to \$3.5 million, an increase to a 45% estate tax rate, and the reinstatement of the gift tax exemption of \$1 million. Importantly, the budget proposals have also reintroduced changes to common estate planning tools:

- **Valuation Discounts.** Many people often apply discounts in valuing interests in closely held businesses due to various restrictions placed on the shares or units such that gifts or bequests are generally valued at less than what some may consider fair market value. The administration is proposing that intra-family gifts or bequests of these entity interests will be valued without taking into consideration various restrictions, thus eliminating some of the benefit of discounts.
- **GRATs.** Grantor Retained Annuity Trusts (GRATs) have been used to transfer assets to a trust in return for an annuity over the term: the value of the GRAT for gift tax purposes is less than the value of what is transferred into trust. Right now, GRATs can have a term as short as two years. If the value of the trust assets increases by more than the annuity payments, then it is successful as the excess appreciation will pass to the remainder beneficiaries. However, the administration is discussing requiring the GRAT to have at least a 10 year term. This increases the risk that the grantor will pass away during its term and all or part of the GRAT will be included in his or her estate.

With the recent changes and the proposed changes, what does it mean to you?

MAKE LARGE GIFTS NOW. With the increased gift tax exemption of \$5 million, now is the time to make large gifts. Gifting now would freeze the value of the gifted property and would remove post-gift appreciation and income from your (potentially taxable) estate. Also, there is no Washington state gift tax; therefore lifetime gifts by Washington residents are not subject to a transfer tax at the time, and the gifted property will escape the Washington estate tax.

The increased gift tax exemption can also be used to pay for large life insurance policies owned by a trust, without incurring gift tax or using loans or other complex premium leveraging techniques. Also, if you have a split dollar arrangement involving life insurance with your employer, the higher gift tax exemption may be useful in terminating certain grandfathered “equity collateral assignment split-dollar” arrangements involving trusts, with little or no gift tax consequences.

Combining the larger gift tax exemption with the available valuation discounts, it may be most beneficial to transfer interests in your business or real property within family now. The current state of estate tax may provide for important opportunities in succession planning.

There are many more gifting options to consider now. Consider making use of the increased GSTT exemption to fund Dynasty trusts, to provide significant, long-term estate tax savings for your descendants. Review whether GRATs are a useful tool given your assets and whether you should take advantage of the current law allowing for shorter term GRATs. Smaller gifts can also still be made using the annual gift tax exclusion of \$13,000 per person or paying tuition or medical expenses for the benefit of someone else—these gifts do not impact your exemption and can be an effective step in reducing your estate.

EVALUATE TRUST PROVISIONS. If your Will contains provisions for automatic funding of a ‘credit shelter trust’ (also called an “exemption trust” or a “bypass trust”), you may wish to consider switching to a more flexible type of Will. A Disclaimer Will leaves everything outright to the surviving spouse, but gives the surviving spouse the option to create an estate-tax savings trust, if needed at that time. This puts off planning decisions until the passing of the first deceased spouse, when more information will be available that will affect these decisions.

We do recommend that our married clients retain either an automatic trust, or an option to create a “disclaimer trust,” in their estate planning documents. A trust provides the advantage of sheltering future appreciation from potential estate tax, and also can provide creditor protection for the beneficiaries. In addition, the new federal rules for exemption portability are effective only for 2011 and 2012. The Washington state estate tax exemption remains at \$2 million and there is no provision for portability of the state exemption between spouses. Therefore, including an optional disclaimer trust or an automatic credit shelter trust in your documents will still be the best estate planning option for most married couples.

IMPACT ON 2010. Prior to the recent changes, the estates of decedents who died in 2010 were not subject to federal estate tax, though the estates also had limited step-up in the basis of its assets. Now the estates have a choice between electing the new, 2011 tax laws (including the step-up in basis for income tax savings) or using the 2010 rules (i.e., unlimited federal estate tax exemption; limited step-up in basis of assets). The decision whether to opt out of the new tax laws is complex and depends on many factors.

* * *

The above changes in federal laws are effective only in 2011 and 2012, but do present some important planning opportunities. Although it is impossible to predict what laws will be in effect once the new rules expire (December 31, 2012), many commentators predict that, due to budgetary considerations, Congress will be forced to enact harsher estate tax laws (i.e., a lower exemption and/or higher federal estate tax rates) to take effect after 2012. While recent budget proposals do propose limits similar to 2009, there could also be a reinstatement of the pre-2001 rates (\$1 million exemption and 55% estate tax rate) if nothing is done.

With the advantageous planning opportunities and the potential complexities in our current estate tax environment, it is important to contact your professional advisors to discuss your estate planning concerns further. It could be important for you and your family.

Please contact Ryan Swanson's Estate Planning & Tax Group with questions:

Lance Losey, Chair and Member, losey@ryanlaw.com or 206.654.2256; **Joel Paget**, Member, paget@ryanlaw.com or 206.654.2215

Kari Brotherton, Associate and CPA, brotherton@ryanlaw.com or 206.654.2227; **Nancy Kennedy**, Of Counsel, kennedy@ryanlaw.com or 206.654.2233;

Deborah Leitner, Paralegal, leitner@ryanlaw.com or 206.654.2224