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Dear Clients and Friends:

Last Friday, President Obama signed into law a tax reform package extending through 2012 many tax cuts that were scheduled to expire at the end of this year. Tucked in among the Act's provisions were significant changes to the estate and gift tax laws. This Act is temporary and it sets the stage for another political showdown in just two short years, but we believe it carves a new landscape for estate tax planning that will be difficult to reverse in the next Congress. For the short term, these new rules will steer our recommendations regarding how families transfer wealth from one generation to the next. Here is a quick summary:

I. Bigger Estate Tax Exemption; Lower Tax Rate

Retroactive to January 1, 2010, the estate tax exemption is bumped to $5 million and will be adjusted for inflation going forward. The federal estate tax rate is also cut to 35%. This means that without any deductions, the estate of a person dying with $6 million in assets will pay $350,000 in estate tax, or 35 cents for every dollar beyond $5 million. Without the changes, the same $6 million estate would have generated $2.75 million in tax.

For Executors handling estates of decedents who died in 2010, a new set of questions comes up because the law gives them the option of (a) claiming the $5 million estate tax exemption, paying any tax due at the lower 35% rate, and wiping out all capital gains tax on appreciated property in the estate; or (b) opting out of the estate tax and passing assets through the estate with a modified carryover basis, leaving the heirs to pay capital gains tax on gains over $1.3 million.

We would expect Yankee-owner George Steinbrenner's estate to choose path (b), because the capital gains tax rate is now much lower than 35%, but that decision carries the risk of higher capital gains tax rates when George's children sell the team in the future. Other estates will have the same difficult decision to make.

II. Estate Tax Exemption "Portability"

Beginning in 2011, estate tax exemptions will become "portable" between spouses, which means that a surviving spouse might be able to take advantage of the unused exemption left behind by a deceased spouse. That sounds good, but there are several pitfalls buried in this provision. For example, the first spouse cannot have died before January 1, 2011. That is, the "portability" of exemptions starts only next year. Second, a surviving spouse who wants to remarry will need to consider the impact that marriage would have on the maximum value that he or she could pass on to his or her children, because only the exemption from the most recently deceased spouse counts.

Third, this tax reform package is a temporary measure, meaning that "portability" might disappear in a couple of years even if the exemption boost and rate cut are made permanent. Finally, "portability" raises the question of whether an estate tax return should be filed for every married decedent to establish the 'unused exemption amount' that would carry over to the surviving spouse. We think the unintended consequences of this "sounds good" provision might be worse than the old way, which allowed couples to accomplish the same thing with credit shelter trusts.

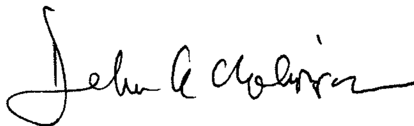
III. Generation-Skipping Transfers

Since 1976, Congress has imposed an extra transfer tax on gifts or bequests to grandchildren and other beneficiaries at least two generations away from the donor, called generation-skipping transfers or "GSTs". Last week's reform set the GST tax rate for 2010 transfers at zero - ***yes, 0%***. We thus have a short opportunity to make GSTs with only gift tax concerns, so that if a 2010 transfer into a GST trust is excluded from gift tax (perhaps by using the $13,000 annual exclusion), then no tax will be applied when the trust is funded or when distributions are made from that trust to beneficiaries in the future. For clients with a net worth of more than $5 million, this planning opportunity deserves attention, and fast – this "freebie" expires next Friday, December 31st!

IV. Impact on Our Clients

We wish that the estate tax reform had been given permanent effect and that we would now have some certainty to guide clients trying to minimize taxes as they pass legacies on to their children and grandchildren. However, just like the law passed in 2001 which created the circumstances forcing this last-minute tax reform, the new 2010 Act has a sunset provision that will cause taxes to rise again on January 1, 2013 without further Congressional action. What will be done then? We surely can't predict that now. But we can say this: we will be here to keep you informed and to guide you in your planning decisions. Please give us a call if you have questions.

Sincerely yours,



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