

WIGGIN AND DANA
Counsellors at Law

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2010 Federal Estate, Gift & GST Tax Changes May Affect Your Estate Plan

Late last year, the Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 was enacted. In addition to extending many of the Bush-era tax cuts for 2011 and 2012, including setting the maximum income tax rate at 35% and the maximum capital gains rate at 15%, the Act temporarily extends the federal estate, gift and generation-skipping transfer ("GST") taxes for 2011 and 2012.

In this edition of the *Advisory*, we will summarize some of the estate, gift and GST tax provisions of the Act and how those provisions might affect estate planning.

WHAT IS THE CURRENT LAW?

- The federal estate, gift and GST tax exemptions are \$5,000,000 per individual. In 2013, the federal estate, gift and GST tax exemptions drop to \$1,000,000.[1]
- The surviving spouse of a decedent who dies in 2011 or 2012 may inherit the unused federal estate tax exemption of the first spouse, up to \$5,000,000 per individual. This concept, called "Portability," is explained in greater detail below.
- The maximum tax rate imposed on estate, gift and GST transfers that exceed the exemptions will be 35% in 2011 and 2012. These rates skyrocket to 55% (and 60% for some large estates) in 2013.
- Recent legislation lowered the Connecticut estate and gift exemption amount from \$3.5 million to \$2 million, and extended the existing 7.2% rate to estates and gifts valued at between \$2 million and \$3.5 million. The lower exemption exposes more estates and gifts to taxation and, because the threshold for taxation is lower, the tax liability for

larger gifts and estates will increase. In light of these developments, if you are a Connecticut resident or own property in Connecticut, it may be advisable for you to modify your existing estate plan.

- The New York estate tax exemption remains at \$1,000,000. There is no gift tax in New York, which may present a planning opportunity for New York residents, as discussed in more detail below.

WHAT DOES THIS MEAN FOR YOU?

Increased Exemptions

For clients transferring wealth in 2011 or 2012, either by lifetime gift or at death, the immediate federal tax liability will be lower. That much is clear.

What remains uncertain is what will happen to a person who exhausts his or her federal gift tax exemption in 2011 or 2012, by making gifts totaling \$5,000,000, and who dies in a year when the federal estate tax exemption is something less than \$5,000,000. Will that person's estate (or the recipients of the gift) owe tax on the prior gift, even though no tax was due when the gift was made? What if the estate does not have the money to pay the tax?

The answers to these questions are not clear as yet. Accordingly, as with any important estate planning decision, if you are considering making a large gift to take advantage of the newly enlarged gift tax exemption, you should be sure to consult with your attorney or other tax adviser *before* making the gift. In general terms, for a person who can afford to make large lifetime gifts, failing to take advantage of the new exemptions may represent a wasted opportunity. To hedge against the risk of taxation of the gift at the individual's death, it may be advisable to make the gift to a trust

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rather than outright. If tax is subsequently levied on the gift, it may be possible to draft the donor's will in such a way that the tax can be collected from the trust assets rather than being paid from the individual's estate.

The type of trust utilized depends on the nature of the asset gifted, your planning goals and your financial resources. For example, depressed asset values can make certain trusts, such as Grantor Retained Annuity Trusts (GRATs) and Qualified Personal Residence Trusts (QPRTs) particularly effective. For married clients, Spousal Estate Reduction Trusts (SERTs) may provide necessary flexibility, because as long as certain formalities are observed, a spouse may be the primary beneficiary of this type of trust during his or her lifetime.

For New York residents, the newly enlarged federal gift tax exemption may offer an opportunity to reduce New York estate tax. New York does not impose a separate gift tax. Moreover, prior gifts are not considered when calculating the New York estate tax. For example, assume an unmarried New York resident has assets totaling \$5,000,000, and has not previously made taxable gifts. In 2011 she gives \$4,000,000 to a trust that benefits her grandson. No federal gift or GST tax will be owed on the gift because of the exemptions. If she dies in 2012 with an estate of \$1,000,000, no federal estate tax should be owed because her total gifts and estate do not exceed the \$5,000,000 exemption. No New York estate tax will be owed because her New York estate does not exceed the \$1,000,000 exemption. If instead this client died with assets totaling \$5,000,000, New York estate tax of approximately \$392,000 would be owed (based on 2011 rates.)

Portability

As mentioned above, the new tax law permits a surviving spouse to inherit the unused federal estate tax exemption of a

predeceased spouse in 2011 and 2012. This concept is called "Portability" because the federal estate tax exemption is "portable" between spouses. Some commentators have suggested that Portability eliminates the need to create an Estate Tax Sheltered Trust at the death of the first spouse to shelter the tax exemptions available to him or her. We are not generally recommending that our clients abandon plans to create trusts at the death of the first spouse for the following reasons:

- This law is temporary. Portability is scheduled to expire on December 31, 2012.
- Portability does not apply to state estate tax exemptions, nor does it apply to the federal GST exemption.
- Portability does not account for appreciation of assets in the hands of the surviving spouse. If an estate tax exempt trust is created by the first spouse to die, all appreciation in that trust can escape estate tax at the death of the surviving spouse. If Portability is relied upon, there is no sheltering of appreciation from estate tax.
- Portability is complicated upon remarriage of the surviving spouse, and the unused estate tax exemption of the first spouse may disappear.

In conclusion, the new tax law provides historically generous exemptions from the federal estate, gift and GST taxes. Planning to properly consider these exemptions is crucial, including for individuals whose estates do not exceed \$5,000,000.

If you would like additional information about the current estate and gift tax laws, gifting strategies and other estate planning matters, please feel free to contact one of our experienced trusts and estates attorneys. Our names and contact information are listed in the left hand column of this Advisory.

[1] The GST exemption will be somewhat higher than \$1,000,000 because it is indexed for inflation from 1997 to 2013.