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2010 TAX LAW NOTICE (FOR MARRIED COUPLES)

After what has seemed an interminable wait, Congress has finally taken action to provide new rules regarding the taxation of decedents' estates and other wealth transfers. On December 18, 2010 President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Relief Act"), legislation that extends the Economic Growth and Tax Relief Reconciliation Act of 2001 for two years, temporarily increases exemptions from the estate, gift and generation-skipping transfer ("GST") tax from their 2009 levels, and temporarily reduces the estate, gift and GST tax rates. Had Congress waited another two weeks to act, the 1986 law, with its $1 million estate tax exemption and 55% rate, would have been the law of the land. So where do we go from here? To learn more about the details of the 2010 Tax Relief Act and how it may affect your estate plan, please read on.

New Exemption Levels and Tax Rates. The 2010 Tax Relief Act provides for a $5 million unified estate and gift tax exemption in 2011 and 2012, and a 35% tax rate for estates and gifts exceeding the $5 million exemption. Under the 2001 law, the lifetime gift tax exemption was $1 million, so the new law allows for substantially more gifting before a gift tax must be paid. The GST tax exemption amount is also set at $5 million and a 35% rate for the next two years.

The effective date of the new estate and GST exemption levels is January 1, 2010 (although estates of decedents dying in 2010 may elect an unlimited exemption while being bound by the carryover basis rules), whereas the effective date of the new gift tax exemption level is January 1, 2011.

Portability of Estate and Gift Tax Exemptions. One of the unique features of the new law is that it allows a surviving spouse to use the exemption amount unused by a predeceasing spouse. In order for the unused exemption to be portable, however, the spouse who is first to die must have died after December 31, 2010. So, if John Smith dies in 2011 and uses only $3 million of his $5 million federal estate tax exemption, his widow, Jane Smith, would have $7 million of estate tax exemption available for use at her death if John's personal representative (executor) preserved the use of his unused exemption by filing a federal estate tax return. This assures that John and Jane will be covered by a $10 million estate tax exemption for their combined wealth no matter how their assets are titled. John's unused exemption would not be lost if Jane remarried, but if Jane's new spouse predeceased Jane, Jane's available exemption would be $5 million plus any exemption unused by her second spouse.

The same rules regarding portability of estate tax exemptions also apply to lifetime gift tax exemptions. Therefore, if John Smith had used up $3 million of his lifetime gift tax exemption prior to his death, Jane would have $7 million of gift tax exemption available assuming she had used up none of her lifetime exemption prior to John's death.[1] Again, Jane's

[1] The federal system of estate and gift taxation is unified. In other words, in the above example if John Smith had used up $3 million of his lifetime gift tax exemption prior to his death, his federal estate tax exemption effectively would be $2 million ($5 million minus $3 million). Therefore, any amount of John's estate exceeding $2 million at his death would be subject to federal estate tax. This federal estate tax, however, could be deferred until Jane's later

remarriage will affect the portability of John's unused lifetime gift tax exemption only if Jane's new spouse predeceases Jane.

Also, while the new law provides that estate and gift tax exemptions are portable between spouses, no such portability is provided with respect to exemptions from the GST tax.[2]

Expiration of 2010 Tax Relief Act. The new legislation, with its taxpayer friendly exemption levels, tax rates and portability provisions, will sunset on December 31, 2012. If Congress does not pass a law between now and then, the 1986 law, with features such as a $1 million federal estate tax exemption and a 55% tax rate, will spring back into existence. Given the wide disparity between the exemption levels and rates of the 2010 and 1986 laws, it is probably a fair bet that in 2013 and future years we will not see exemption levels and rates as they existed under the 1986 law. However, in light of an unpredictable Congress, fickle electorate and the fiscal woes facing our national treasury, it would not be prudent to base an estate plan on such an assumption.

Frequently Asked Questions. Given the short term nature of the new legislation, many clients once again find themselves conflicted over whether to wait for more permanent legislation or commit to revising their existing plans now. To help with this decision, I provide answers to questions which may be on your mind.

Q: In light of the portability of exemptions between spouses and other features of the 2010 law, is it necessary that our Wills contain provisions creating credit shelter trusts upon the death of the spouse who is first to die?

A: Probably so, and especially for married couples with substantial wealth and those who intend to remain Maryland residents.

- As mentioned, the current law expires on December 31, 2012. Since flexibility is the linchpin of any good estate plan, your estate planning documents should contain provisions which deal with the possibility that Congress may lower the exemption amount from its current level or eliminate the portability provision.

- Even though the exemption from the federal estate tax is $5 million, the exemption from the Maryland estate tax remains at $1 million and is showing no signs of increasing in the foreseeable future. While the maximum Maryland estate tax rate is 16%, much lower than the federal estate tax rate, most clients wish to avoid paying an estate tax at the death of the spouse who is first to die. As an example, assume John Smith dies in 2011 with a $3 million estate and his Will directs that all of his assets shall pass to his spouse, Jane, outright. Further assume that Jane inherits the family home worth $1 million by operation of law (it was

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death if that excess passed either outright to Jane or to a trust for Jane's sole benefit which qualified for the unlimited marital deduction.

[2] The federal GST tax is a separate tax which taxes transfers made by a transferor directly to a grandchild or more remote descendant or a transfer from a trust created by the transferor to a grandchild or more remote descendant. The benefit of creating GST exempt trusts either during one's lifetime or upon death is that the trust assets, and all appreciation thereon, may be forever exempt from tax on the estates of the transferor's children and more remote descendants, and distributions from the trust to grandchildren and more remote descendants will be exempt from the GST tax.

jointly owned between John and Jane) and that she has assets titled in her own name worth another $1 million. If Jane dies in 2012 with an estate of $5 million, there will be no federal estate tax due, but a Maryland estate tax of $391,600 will be due. Had John's Will provided that at least $1 million of his estate should pass to a credit shelter trust of which Jane could be the primary beneficiary, Jane's estate would have owed only $280,400, a difference of $111,200. This difference would be even more significant if Jane died much later than John and the assets in the credit shelter trust appreciated in value in the interim.

- Credit shelter trusts will also continue to be useful because all appreciation in the value of assets distributed to a credit shelter trust at the death of the spouse who is first to die will be excluded from the surviving spouse's estate. Example: John Smith dies in 2011 with an estate worth $5 million and his Will directs that assets in his estate up to the exemption amount from the federal estate tax passes to a credit shelter trust. Jane Smith dies in 2021 with an estate then worth $5 million. Between 2011 and 2021, the credit shelter trust grows from $5 million to $8 million. If the exemption level in 2021 continued to be $5 million, no federal estate tax would be due as a result of Jane's death. Conversely, if John's Will had provided that his entire estate passed outright to Jane, Jane would die with an estate worth $13 million and a federal estate tax would be due since the maximum exemption she could use would be $10 million (her $5 million exemption plus the $5 million unused by John). If the exemption amount decreased between 2011 and 2021, even more tax would be due at Jane's death.

- There are several non-tax reasons to create a shelter trust upon the death of a spouse who is first to die, as opposed to leaving such assets outright to the surviving spouse, such as protecting the assets from the claims of the surviving spouse's creditors, protecting the assets from either inadvertent or intentional planning by the surviving spouse which causes children to be disinherited, and protecting the assets from excess spending or improvident decisions made by the surviving spouse.

Q: What happens if I own assets worth more than $1 million and my Will provides that an amount up to my exemption from the federal estate tax passes to a credit shelter trust for the benefit of my spouse and my children, with any excess passing either outright to my spouse or to a trust for her sole benefit? Will a Maryland estate tax be due if I die in 2011 or 2012 predeceasing my spouse?

A: Yes. Since only $1 million is exempt from the Maryland estate tax, if a traditional credit shelter trust were funded with assets exceeding $1 million, a Maryland estate tax would be due. Example: John Smith dies in 2011 with a $5 million estate, all of which by the terms of his Will passes to a credit shelter trust for the benefit of Jane Smith and their three children. While no federal estate tax would be due, a Maryland estate tax of $391,600 would be due as a result of John's death. If John wanted to avoid the payment of any Maryland estate tax at his death, his Will should provide that any amount of his credit shelter trust in excess of $1 million should pass to a sub-trust for the sole benefit of Jane, from which Jane would be entitled to the net income on a quarterly or more frequent basis. This way, $4 million of John's $5 million estate would qualify for the unlimited marital deduction under Maryland law and, with the other $1 million exempt, there would be no Maryland estate tax due as a result of John's death. John's personal representative (executor) on John's federal estate tax return would elect not to qualify the sub-trust for the unlimited marital deduction from the federal estate tax so that all $5 million, and all future appreciation thereon, would be exempt from federal estate tax at

Jane's later death. Unfortunately, the sub-trust initially funded with $4 million would be includible in Jane's estate for Maryland estate tax purposes, but there are methods that the trustee and Jane could use over Jane's lifetime to reduce the value of the sub-trust, and if Jane were to move to a state where no estate tax existed, such as Virginia or Florida, a compelling argument could be made that none of the sub-trust assets would be subject to Maryland estate tax.

Q: Now that portability of exemptions is permitted, is it necessary for my spouse and I to divide assets so that each of us has in our individual names assets of approximately equal value?

A: Putting aside state estate tax implications for the moment, if you are confident that the combined estates of you and your spouse will never exceed $10 million and are willing to assume that Congress will not reduce exemption levels substantially from their current levels or eliminate the portability feature, it may not matter that most of the family wealth is concentrated in the hands of one spouse since the "richer" spouse can use the unused exemption of the "poorer" spouse if the poorer spouse were to die first. However, since exemptions from the GST tax are not portable between spouses, married couples wishing to maximize the amount that will be exempt from the GST tax, and the federal estate tax in their descendants' estates, ought to have $5 million of assets in each of their names.

Also, since Maryland law does not provide for the portability of the exemption from the Maryland estate tax between spouses, individuals wishing to shelter $1 million (the amount exempt from Maryland estate tax) from their spouse's estate would be best served if each spouse had assets titled in his or her individual name worth at least $1 million.

Q: If my spouse and I have "Disclaimer Trust Wills" do any revisions need to be made in light of the new law?

A: Probably not. A Disclaimer Trust Will provides that all assets pass to the surviving spouse but that the surviving spouse, if he or she acts within nine months of his or her spouse's death, may disclaim (refuse to accept) the assets being left to him or her. The assets so disclaimed pass to a credit shelter trust, of which the surviving spouse, and possibly children, are the beneficiaries.

These types of Wills will continue to be effective under the new law, but as with any planning that depends on affirmative acts of others, the plan is only as good as the action taken by the surviving spouse or his attorney-in-fact if he is incapacitated. Also, one would want to consider making sure that the Will provides that any amount disclaimed in excess of $1 million passes to a sub-trust that qualifies for the unlimited marital deduction from the Maryland estate tax for the reasons mentioned above.

Q: What estate planning opportunities are presented by the new law?

A: • Gifts Made Directly to Family Members. For individuals who could afford to make gifts to family members without affecting their lifestyles, it was always prudent under prior law to annually make gifts to family members in amounts that did not exceed the annual exclusion from the federal gift tax for each gift made (currently $13,000 per year per donee). Gifts made to family members in excess of the annual exclusion amount were required to be reported on federal gift tax returns, and the amount reported counted toward the use of the donor's lifetime gift tax exemption and eroded the donor's estate tax exemption. If the reported amounts exceeded $1 million over the donor's lifetime, the donor had to pay a gift tax (45% in 2009).

With the lifetime gift tax exemption now pegged at $5 million, donors who have the wherewithal to do so can continue to make annual exclusion gifts but may also wish to make very substantial gifts to family members since no gift tax must be paid until such gifts exceed $5 million. Moreover, unlike the transfer tax system under federal law, Maryland, for estate tax purposes, does not add lifetime gifts made in excess of the annual exclusion to a decedent's taxable estate. Also, Maryland presently imposes no gift tax. Therefore, individuals may reduce their Maryland estate tax burden significantly by giving away assets during their lifetime. Example: Jane Smith is widowed and has an estate worth $5 million. No federal estate tax will be due if she dies in 2011 or 2012, but a Maryland estate tax of $391,600 will be due. If Jane's pension income was sufficient to maintain her lifestyle and she felt that she did not need to own assets in excess of $1 million, she could give $4 million to her children. No federal gift tax would be due since the lifetime gift tax exemption is $5 million, and for the reasons stated above, no state gift tax would be due. Assuming that Jane made sure that assets in her own name never exceeded $1 million, no Maryland (or federal) estate tax would be due as a result of her death.[3] If Jane wished not to give as much away and instead died with an estate having the following values, the following Maryland estate taxes would be due: $4 million estate/$280,400 tax; $3 million estate/$182,000 tax; $2 million estate/$99,600 tax.

- Intra-Family Loans. As long as a loan is made with interest charged at a rate no lower than the applicable federal rate published by the Treasury Department for the month in which the loan is made, the principal amount of the loan will not be treated as a gift. The January 2011 applicable federal rate for loans of a duration greater than nine years, assuming payments are made quarterly, is 3.82%. For loans of a duration of between three and nine years, the January applicable federal rate is 1.94%, and for loans of one to three years the January rate is 0.43%. For instance, in January a parent could loan $100,000 to a child for a 30 year period and the child would only have to pay the parent $3,820 in yearly interest.

- Grantor Retained Annuity Trusts (GRATs). Individuals wishing to transfer to their children significant future appreciation of their estates would be wise to consider creating a grantor retained annuity trust, or GRAT as it is commonly known. Under a GRAT, a parent irrevocably transfers assets to a trust and each year receives an annuity from the trust. At the end of the trust's term if the assets have appreciated at a rate in excess of a rate published monthly by the Treasury Department, referred to as the "hurdle rate," the excess amount passes to the children. Example: John Smith creates a GRAT in January 2011 and transfers to the trust shares of IBM worth $1 million. The terms of the trust agreement creating the GRAT provide that John will receive annual distributions from the trust of $518,081 for a two year period and at

[3] Under the 2010 law, and consistent with prior estate tax laws, any assets owned by Jane at her death receive a step-up in cost basis. Therefore, if the only assets that Jane had to give to family members consisted of assets with a very low cost basis, she would be well advised to compare the benefits of making substantial family gifts (and avoiding Maryland estate tax) with the benefits of her heirs receiving assets with a stepped-up cost basis to avoid a capital gains tax if the gifted assets were ever sold by family members.

the end of the two year period the trust remainder will be distributed equally to John's three children. The January 2011 hurdle rate published by the Treasury Department is 2.4%. Therefore, if the price of IBM stock were to increase 10% in each of the trust's two years, the remainder interest distributable to the children would be $122,029.90, while the gift that John would have to report on a federal gift tax return would be less than $1 because the gift is determined by formula at the inception of the GRAT, not at its termination. There is much more to discuss regarding the mechanics of GRATs and suggest that if you are interested in this technique that you contact me to obtain more details.

- Charitable Lead Annuity Trusts (CLATs). Those wishing to benefit both their favorite charities and family members may wish to consider a charitable lead annuity trust or CLAT. A CLAT works much in the same way as a GRAT, except that a charity receives the annuity payments rather than the individual creating the trust and an income tax charitable deduction may be taken for the amount passing to charity.

Conclusion. The 2010 Tax Relief Act is good news for taxpayers even if the Act only has a two year duration. It may not be cause for a wholesale change of your estate plan, however. Nonetheless, you will want to make sure that your current estate planning documents still meet your estate planning goals and that they appropriately navigate both the federal and Maryland laws regarding wealth transfers. The new law also presents historic opportunities for lifetime wealth transfers, and you should carefully consider which approach to take depending on your available resources and your desire to minimize transfer taxes. These discussions are most fruitful when occurring face to face, so please feel free to contact me for an appointment if you wish to discuss these subjects in more detail.