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Estate Planning Alert

November 2010

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CAUTION: Congress is currently considering revisions to the estate, gift and generation-skipping transfer tax laws, which may affect the information in this newsletter. Given the uncertainty, consult a knowledgeable tax advisor before taking any action in reliance on these materials.

Last-Minute Transfer Tax Planning Opportunities for 2010

Gifting

Taxable gifts made in 2010 (that is, gifts that do not qualify for the annual gift tax exclusion and are not made directly to a provider to pay for the donee's medical care or tuition) are subject to a 35 percent gift tax to the extent their value exceeds the donor's available lifetime gift tax exemption ($1,000,000). Beginning January 1, 2011, this 35 percent tax rate will increase to 55 percent.

Therefore, wealthy taxpayers who (i) believe they will have a taxable estate at death and (ii) do not expect to need all of their assets to maintain their standard of living should consider "pre-funding" their beneficiaries' inheritance through outright gifts or gifts to irrevocable trusts in 2010.

Generation-Skipping Transfers

Since 1985, there has been a generation-skipping transfer tax (referred to as the "GST Tax") imposed on gifts or bequests made to a person who is two or more generations below the donor or decedent. The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the GST Tax for 2010. However, absent further congressional action, it will re-emerge on January 1, 2011, at a rate of 55 percent (or 60 percent in limited cases). In addition, the GST Tax exemption, which stood at $3,500,000 at the end of 2009, will fall to roughly $1,400,000 in 2011.

For taxpayers contemplating future gifts or bequests that could be exposed to the GST Tax, and for trustees and beneficiaries of existing trusts that are not exempt from the GST Tax but from which future distributions may be made to beneficiaries who are two or more generations below the settlor, the remaining days of 2010 present a valuable, but possibly short-lived, planning opportunity.

For individuals, a 2010 gift made directly to an adult grandchild or more remote descendant will certainly fall outside of the reach of the GST Tax. Many believe a 2010 gift to a custodian under a state's Uniform Transfers (or Gifts) to Minors Act or a trust solely for the benefit of a second-generation or more-remote descendant (in other words, a trust with no first-generation beneficiaries) will also escape the GST Tax, but this is not certain. No one knows exactly how the reinstatement of the GST Tax in 2011 will affect UTMA and trust gifts made in 2010, so taxpayers should secure specific advice as to the possible impact of the GST Tax before making any transfers to a trust or custodial account in 2010. Of course, any gift in excess of the taxpayer's available lifetime gift tax exemption will be subject to gift tax.

For trustees and beneficiaries of a trust created after October 22, 1986, that has the potential for future exposure to GST Tax, distributions from such a trust in 2010 to a grandchild or more remote descendant will similarly avoid exposure to GST Tax.

For taxpayers who have been considering making gifts to grandchildren, and for trustees who have refrained from making distributions to grandchildren or more-remote beneficiaries due to concerns about the application of the GST Tax, the remaining weeks of 2010 provide a unique opportunity to make such distributions without GST Tax concerns. In some instances, it may be possible to fully terminate a trust in 2010 that otherwise would be exposed to the GST Tax.

Taxpayers who would like to consider taking action before year-end should do so immediately. However, they may wish to wait until Congress recesses in December, when the threat of retroactive tax legislation will end, before putting their plans into effect.

Valuation Discounts

Over the years, various administrations have supported the IRS in its quest to limit valuation discounts for lifetime and testamentary transfers of interests in family-owned entities. Given the increasing need for additional tax revenue, few would be surprised to see a similar proposal as part of any future legislation affecting the estate and gift tax. It is also possible that the Treasury Department may issue regulations that attempt to limit the availability of family control discounts. Therefore, anyone considering such transfers may wish to act before the end of 2010.

Grantor-Retained Annuity Trusts

Taxpayers and their advisers continue to expect that Congress will soon make it more difficult to use a grantor-retained annuity trust ("GRAT") as an effective wealth transfer vehicle. However, it is still possible — at least for the time being — to use GRATs to shift value to the next generation with little or no gift tax cost, while minimizing the risk of adverse estate tax consequences if the grantor dies during the annuity term.

A GRAT is an irrevocable trust that pays the grantor a defined amount each year for a specific number of years. At the end of this annuity term, the remainder is distributed to (or held in trust for) the grantor's beneficiaries.

When the GRAT is created, the grantor is treated for tax purposes as making a gift of the remainder interest. However, in valuing that gift, the Internal Revenue Service makes certain assumptions, including the rate at which the trust assets are expected to appreciate during the annuity period. This assumed growth rate is currently at an all-time low (2.0 percent for GRATs created in November 2010), which minimizes the tax cost of the gift. If the trust assets actually appreciate at a faster rate than the IRS assumes, the excess will pass as part of the remainder to the grantor's beneficiaries free of gift tax.

In addition, current law allows a grantor to create a GRAT with an annuity term of only two or three years. Restricting the annuity period in this fashion reduces the risk that the grantor will die during that time and thereby cause the trust assets to be included in his or her estate for estate tax purposes. Unfortunately, when Congress acts, it is expected to require a minimum term of 10 years for any new GRAT, which will make them less attractive for taxpayers with shorter life expectancies.

Taxpayers with assets that are expected to appreciate at a faster rate than the IRS's assumed rate are excellent candidates for a GRAT, but only if they act before the rules are changed.

Expanded Roth IRA Rollovers

High-income taxpayers have historically been unable to take advantage of the many potential tax benefits offered by Roth IRAs because they could not contribute to one, either directly or through a traditional IRA rollover. However, beginning in 2010, any taxpayer, regardless of income or filing status, may convert amounts in a traditional IRA or an employer-sponsored retirement plan to a Roth IRA. In addition, the Small Business Jobs Act of 2010 permits employers to amend their 401(k) and 403(b) plans to allow participants to convert amounts after September 27, 2010, by transferring them into a designated Roth account within the same plan. (Section 457(b) plan sponsors may do the same beginning in 2011.)

For conversions made in 2010 only, the taxable portion is not required to be included in the taxpayer's income until 2011 and 2012 (one half in each year). If the taxpayer later regrets a conversion decision made in 2010 (for example, if the account declines in value following the conversion), he or she has until October 17, 2011, to recharacterize it by transferring all or part of the amount to a traditional IRA.

Since income tax will be payable on the converted amount, however, a Roth conversion may not be advisable for everyone. If a taxpayer expects to be subject to a lower income tax rate in the future, more income tax may be paid overall with a conversion. Similarly, a conversion may not be appropriate for taxpayers who are near retirement age and expect to rely on future distributions to supplement their income.

Drafting an Estate Plan in 2010 or 2011

"Nothing is certain but death and taxes," or so the saying goes. But in 2010, even death and taxes are uncertain, and some of that uncertainty may remain into 2011 and beyond.

If someone dies on December 31, 2010, his or her estate will not be subject to federal estate tax under current law. By contrast, if someone dies on January 1, 2011, the federal estate tax will apply with a 55 percent maximum marginal rate and an exemption of $1,000,000, although Congress may soon change these numbers. In addition, one often-discussed possible change would be the addition of a "portable" estate tax exemption from spouse to spouse, which might simplify planning for many couples in the long run but which might also require amendments to an existing plan.

Given these wildly different results depending on the hour of death and possible future legislation, drafting a will and other estate planning documents has never been more difficult. The process can be complicated even further for someone who may become incompetent in the not-so-distant future, and therefore unable to amend their estate plan in the future to address subsequent changes in the law.

Since no one can predict the time of death or incompetency, prudence dictates having documents that can reasonably be expected to cover the various contingencies.

→ For example, in some cases, it may be advisable to include express provisions for dealing with the absence of an estate tax in 2010, or the possibility, however unlikely, of a retroactive reinstatement of the estate tax this year.

→ Also, asset basis allocation planning may be an issue for some, particularly given the possibility of increased capital gains tax rates in the future. Unless Congress changes the rules retroactively, assets passing through the estate of someone dying in 2010 will receive only a modified carryover basis for capital gains purposes, and not the popular step-up in basis that existed in prior years and is expected to return in 2011.

→ Similarly, for many clients, the estate documents should include provisions that will minimize and delay taxes in 2011 and beyond, including flexibility to adjust the plan depending on the then-applicable estate tax exemption.

In all cases, it is best to confirm that the existing estate plan continues to make sense in light of the current legislative uncertainty. Will the document language accidently result in an important family member, such as a spouse or child from another marriage, being disinherited if the estate tax laws change? Is there the potential of triggering significant unintended taxes or, conversely, missing opportunities to greatly minimize taxes?

To possibly complicate matters further, several states, including Virginia and North Carolina, require estate tax-related terms in many wills and trusts drafted before 2010 to be interpreted as if the decedent died in 2009. While such legislative patches can be helpful, they do not necessarily optimize planning and may, in fact, actually trigger taxes unnecessarily in certain situations. Even documents drafted after 2001 that specifically anticipated the repeal of the estate tax may not take into account the possible retroactive reinstatement of the estate tax.

If the estate tax exemption returns to $1,000,000 in 2011, many more people will find that they can benefit their families by incorporating tax planning into their wills and trusts. The advantages of making sizeable lifetime gifts will also increase, as will the benefits of transferring certain life insurance policies to irrevocable trusts in order to keep the proceeds out of the insured's taxable estate. Appropriate asset titling and beneficiary designation provisions will continue to be of critical importance to ensure that the plan will work as intended.

It has always been best to review estate plans every two or three years. In these uncertain times, such a review becomes even more critical.

For Executors and Trustees: Death in 2010

Recent headlines in the popular press have touted the windfall received by the heirs of George Steinbrenner and other wealthy individuals dying in 2010 without being subject to an estate tax. Whether or not Congress enacts retroactive legislation to prevent that outcome, however, death in 2010 undoubtedly creates significant difficulties for those charged with administering a decedent's estate.

First, the specter of retroactive reinstatement of the estate tax remains real, although most believe the risk has decreased as the end of the year approaches. But until the final outcome is clear, executors and trustees do not know whether to plan for the payment of any estate tax that may be due. They may not even know how assets should be distributed if the document terms are unclear or are contingent on there being (or not being) an estate tax.

Executors and trustees should not distribute assets to the decedent's beneficiaries until they have been identified with certainty and adequate provision has been made for payment of any possible estate tax liability.

Also, while there is currently no requirement to file an estate tax return, such a return could become due if the estate tax is resurrected retroactively for 2010. The estate tax return for someone who died on January 1, 2010, was due October 1, 2010. Although prior to 2010, an executor could request an automatic six-month extension (which for decedents dying on January 1, 2010, would extend the filing date to April 1, 2011), it is unclear how such an extension could be requested when there is no requirement to file an estate tax return in the first place. Presumably any retroactive application of the estate tax would give executors a reasonable time to comply after the law is passed, but nothing is certain. It is also possible that Congress could allow executors to choose whether to be taxed under the 2009 or 2010 rules, which would raise additional fiduciary concerns because the choice could well impact beneficiaries differently.

Under the 2009 rules (which are currently scheduled to return in 2011), the decedent's assets generally received a step-up in basis to the fair market at the date of death for capital gains purposes. However, under the 2010 rules, a decedent's beneficiaries receive assets with a modified carryover basis (that is, the decedent's basis), which in many cases will be what the decedent paid for the asset years before. If the decedent's basis cannot be determined, it may be assumed to be $0.

The carryover basis rules include a number of special provisions, including a limited $1,300,000 basis step-up that the executor may allocate among the decedent's assets in general. There is also an additional $3,000,000 in allocable basis for assets passing to a spouse. Unfortunately, none of these provisions is coordinated entirely with existing estate tax concepts. In many cases, they will require affirmative reporting by the executor, and in all cases, they will require executors and beneficiaries to keep detailed records supporting the claimed basis in the event the asset is sold in the future. Beyond these general concepts, no one knows exactly how the carryover basis rules will be implemented or how fiduciaries should report the allocation of the limited basis increases.

The challenge facing executors and trustees today is how to manage the decedent's assets given the absence of fixed rules. For example, standard fiduciary practice might dictate selling assets to diversify, but doing so might trigger significant capital gains if the carryover basis rules apply. Also, some question whether a sale of assets by the executor would prevent a later allocation of basis under the special rules. On the other hand, if the estate tax applies retroactively, an executor might well have preferred to manage market risk by selling assets over time to raise cash with which to pay the tax.

In short, the risk and uncertainty for an executor or other fiduciary in 2010 are great. In some cases, it may even be advisable to defer to a professional fiduciary to manage these issues and the associated risks.

There is no perfect answer or approach to estate administration in 2010. The only certain advice is to proceed cautiously and knowledgably and to keep as many options open as possible until the rules finally become known. Beneficiaries should be advised of the uncertainty and to expect additional delays. Fiduciaries, executors and trustees must tread cautiously, documenting the prudence of their decisions at each step.

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