



**RETHINKING WEALTH TRANSFER, PART 2:  
INITIAL WEALTH TRANSFER CONSIDERATIONS FOR 2011 AND 2012**

A Tax  
Department  
Publication

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Dec. 23, 2010

Human issues are often the hardest part of wealth transfer—deciding “who,” “what,” “when” and “how.” Typically, there are many competing considerations: spouses or life partners to protect; minor or disabled children to support; favorite charities to endow; business succession strategies to refine. Compared with prior law, the Tax Relief Act of 2010 gives us many more opportunities to achieve our goals in a tax efficient manner—in some cases, with less complexity.

Central to the expanded opportunities offered by the Act are three generous \$5 million exemptions that shield transfers from the three federal transfer taxes:

- the gift tax on transfers during life;
- the generation-skipping transfer (“GST”) tax on transfers, during life or at death, that skip a generation; and
- the estate tax on transfers at death.

Transfer Tax Exemptions and Maximum Rates: 2009-13

Tax	2009		2010		2011 - 2012		2013	
	Exemption	Rate	Exemption	Rate	Exemption	Rate	Exemption	Rate
Gift	\$1M	45%	\$1M	35%	\$5M**	35%	\$1M (?)	55% (?)
Estate	\$3.5M	45%	\$5M*	35%*	\$5M**	35%	\$1M (?)	55% (?)
GST	\$3.5M	45%	\$5M	0%	\$5M**	35%	***\$1M (?)	55% (?)

\*Executors for 2010 decedents can also elect into the “no estate tax/modified carryover basis” regime.

\*\*Indexed for inflation, beginning in 2012

\*\*\*Indexed for inflation

A word of caution, however. As shown in the chart above, the \$5 million exemptions and low 35 percent tax rate are in place only through December 31, 2012. On January 1, 2013, absent further action by Congress, the exemptions all fall to \$1 million and the maximum tax rate rises to 55 percent.

Once again, time is short, and the law will favor the thoughtful and the well-advised.

## Gifts

**2011 gift tax basics.** By increasing the gift tax exemption from \$1 million (in 2010) to \$5 million (in 2011 and 2012), the new law gives us an unprecedented, time-limited opportunity to make tax-free lifetime wealth transfers.

**Example One.** Assume that Martha has used none of her lifetime gift tax exemption. In 2011, she gifts 500 shares (valued at \$5 million) of her closely-held business to her son Daniel, who is its chief operating officer. Thanks to the \$5 million lifetime gift tax exemption, she pays no gift tax on the transfer. Over the next 20 years, the value of the shares increases to \$20 million. When Martha dies in 2031, none of that \$20 million is subject to estate tax in her estate.

**Practical pointer #1:** by using her \$5 million exemption before 2013, Martha has “locked-in” the benefits of current law.

**Practical pointer #2:** lifetime gifts of property can be particularly beneficial because they remove not only the asset, but all future appreciation on that asset from the donor’s estate.

**Practical pointer #3:** in the Martha example, the recipient is a child. In other situations, the recipient might be a life partner, a niece or a nephew.

**Practical pointer #4:** a variety of wealth transfer techniques are available that either do not use—or minimize use of—the \$5 million gift tax exemption. These include properly structured intra-family loans, sales to intentionally defective grantor trusts, and transfers to grantor retained annuity trusts or charitable lead annuity trusts.

## Generation-skipping transfers

**Preparation of 2010 GST tax returns in 2011.** The generation-skipping transfer tax is imposed on direct or indirect transfers to “skip persons,” defined to include (i) family members two or more generations younger than the transferor as well as (ii) non-family members more than 37 ½ years younger than the transferor. If you made a generation-skipping transfer in 2010, your Form 709 (gift and generation-skipping transfer tax return) will be due in 2011. The rules governing 2010 generation-skipping transfers in trust are particularly complex (e.g., zero percent GST tax rate and \$5 million GST exemption) and require special attention during the tax return preparation season in 2011. For example, if a GST transfer was made in trust in 2010, the tax return preparer must determine whether to elect out of automatic allocation of GST tax exemption or whether automatic allocation will be helpful. In many cases, donors may wish to rely on the zero percent GST tax rate to save taxes in 2010 rather than use GST tax exemption.



**Practical pointer #5.** As always, be sure your 2010 GST tax return is prepared by someone expert in the preparation of these types of returns, typically an estate planning attorney.

**2011 GST tax basics.** The generation-skipping transfer tax exemption for 2011 and 2012 is \$5 million. This means that a total of \$5 million in lifetime transfers can be made to skip persons without paying GST tax—as long as there is a timely and proper allocation of sufficient GST tax exemption. The \$5 million generation-skipping transfer tax exemption—in conjunction with the \$5 million gift tax exemption—provides a time-limited opportunity to shift wealth to skip persons during your lifetime—without paying transfer tax.

**Example Two.** In 2009, Helen and Steve, a married couple, transfer \$7 million—an amount equal to their combined then-available GST tax exemptions to GST trusts for the benefit of their grandchildren. Their estate planning attorney timely allocates a total of \$7 million of generation-skipping tax exemption to these transfers.

The couple makes no generation-skipping transfers in 2010.

As of January 1, 2011, Helen and Steve each have used \$3.5 million (\$7 million/2) of their respective generation-skipping transfer tax exemptions. Each has \$1.5 million of generation-skipping tax exemption available for additional transfers to skip persons in 2011 and 2012.

**Practical pointer #6:** Individuals who had exhausted their entire \$3.5 million GST tax exemption at the end of 2009 now have an additional \$1.5 million of GST tax exemption available to them in 2011 and 2012 for further transfers.

**Practical pointer #7:** Multi-generational (“dynasty”) trusts can be used to “leverage” the generation-skipping transfer tax exemption.

### **Estate planning**

**Estate tax basics.** The estate tax exemption for 2011 and 2012 is \$5 million, reduced by any gift tax exemption used during life. The estate tax rate on taxable estates in excess of \$5 million is a flat 35 percent.

**Outdated formulas.** Your existing estate planning documents very likely use formulas based on pre-2010 rules, with multiple references to the “estate tax applicable exclusion amount” or the “generation-skipping tax applicable exclusion amount.” (Prior to 2010, “applicable exclusion amount” was the technical term for “exemption.”)

Under these formulas, an exemption trust (also known as a “B trust” or “non-marital trust”) may be funded with an amount equal to the available estate and generation-skipping transfer tax exemptions. Existing formula language in documents—together



with the recent unexpectedly large increase in estate and generation-skipping transfer tax exemptions—can create a disconnect between intent and reality.

**Example Three.** Bill, an Illinois resident, dies unexpectedly in 2011, survived by his second wife Jane, five children from his first marriage and six grandchildren. His estate planning documents were drafted in 2002, when the estate tax and generation-skipping tax exemptions were each \$2 million. Assume that at his death:

- Bill’s taxable estate is \$5 million;
- Bill’s available estate tax exemption is \$5 million; and
- Bill’s available generation-skipping transfer tax exemption is \$5 million.

Existing formula language in Bill’s documents—together with an unexpectedly large increase in the estate and generation-skipping tax exemptions—creates the following disconnect between “intent” and reality.

	<b>“B” Trust</b>	<b>Marital Trust for Jane</b>
<b>Intent</b>	\$2 Million	\$3 Million
<b>Reality</b>	\$5 Million	\$0

In this situation, Jane’s financial future may depend on the terms of the “B” trust. If she is the primary beneficiary, she may have access to both income and principal, just as she would in a marital trust. Jane will not be so fortunate, however, if the primary beneficiaries of the B trust are Bill’s children and grandchildren from his first marriage.

**Practical pointer #8: to truly understand your estate plan, you need to understand what your beneficiaries will receive at your death. Ask your estate planning attorney for a schematic with dollar amounts based on your current net worth. Then consider whether your current plan reflects your intent.**

**Portability of estate tax exemption for married couples.** Under prior law, a married couple would lose the benefit of the first-to-die’s available estate tax exemption if that exemption exceeded the first-to-die’s taxable estate. Typically, this is a problem in common law states, in situations where most assets are titled in one spouse’s name.

**Example Four.** Together, Elaine and Harold hold assets worth \$10 million, of which \$2 million is held in Elaine’s name only. When Elaine dies in 2010, \$2 million of estate tax exemption is applied to reduce her estate tax to zero; the remaining \$3 million expires unused.

The Tax Relief Act of 2010 addresses this problem through a special election mechanism that gives the second-to-die spouse the benefit of the unused exemption of the predeceased spouse, first effective for spouses dying in 2011 or 2012.

**Example Five.** Same facts as Example Four, except that Elaine dies in 2011. Two million of Elaine’s estate tax exemption is applied to her estate and her executor makes a “portability” election. If Harold dies in 2012, then, under the provisions of the new Act, the remaining \$3 million can be added to his available estate tax exemption, giving him total estate tax exemption of \$8 million.

**Practical pointer #9: the 2010 Act does not provide for portability of the generation-skipping transfer tax exemption.**

**Practical pointer #10: even with the ability to transfer estate tax exemption between spouses, those with small estates still need an estate plan. Most basically, wealth transfer planning addresses more than taxes: disposing of your assets can be complicated by factors such as interpersonal dynamics, disability or business succession. In addition, the transferred exemption is not indexed for inflation.**

*Look for a fuller discussion of these issues in the forthcoming second edition of Northern Trust’s Legacy: Conversations about Wealth Transfer.*

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