

TAX NOTES

by C. Arthur Robinson II

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ESTATE TAXES *and the Era of Instability*

by: C. Arthur Robinson, II, Esq.



Congress recently passed the Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 (“2010 Act”) and signaled that we continue to be in an era of relative instability with respect to estate, gift and generation-skipping taxation. The instability started in 2001, but the 2001 Act began a reduction in

rates and an increase in the estate tax exemption which continued through 2009. As has been written about in previous articles, on January 1, 2010, because Congress had not acted, the provisions of the 2001 Act sunset. Under the language of that Act, at sunset, the law reverted to its previous state because that Act provided that its statutory changes would be repealed as if they had never been enacted.

On December 17, 2010, Congress and the Administration finally acted with respect to the estate tax, and while they cleared up a number of extremely troublesome questions, they created others. They also signaled that, unlike the period from approximately 1981-2001 during which the estate tax was stable as a statutory scheme, this period of stability is at an end. It has become clear that changes in the law over the past ten years and the 2010 Act are now part of the landscape. It is also clear that the instability introduced into the law in 2001 and accelerated through 2009 will continue to be part of the estate planning landscape for the foreseeable future.

The 2010 Act deals with both the 2010 tax year as well as 2011 and 2012. For the 2010 year, the estate tax exemption is \$5 million and that tax applies unless

an estate acts to opt out of the estate tax. Undoubtedly, larger estates such as those of billionaires Dan Duncan and George Steinbrenner will opt out of estate tax, and will therefore be subjected to a carryover basis regime which was enacted with the 2001 Act. The manner of opting out and a whole series of questions with respect to uncertainties in 2010 remain to be solved. However, the actions by Congress did provide answers to some extremely troublesome questions, most especially in the area of generation-skipping taxes.

Going forward in 2011, we again have a unified estate and gift tax, and the generation-skipping tax exemption is equal to the estate and gift tax exemption of \$5 million. This exemption will roll forward into 2012 and will be indexed for inflation in that year. Under the current enactment, the same “as if” language which was part of the 2001 Act is part of the 2010 Act. For that reason, if Congress does not take further legislative action on January 1, 2013, the exemption for estate and gift taxes will revert to \$1 million indexed for inflation as will the generation-skipping tax exemption, and a whole host of other statutory changes, some good and some bad for taxpayers, will be swept away.

Several observations flow from this general description. The first implication for estate planning going forward is that clients can clearly no longer wait for Congress to come to its senses and impose a tax regime, such that clients can plan going forward in an environment of relative stability. To the extent that taxpayers were waiting for the statutory scheme to be rationalized so that they could do appropriate planning,

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INCOME TAX RELIEF: *A Brief Respite*

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In the 2010 Act referred to in the previous article, there were a number of changes, not the least of which were the estate tax changes discussed above. There were also a number of areas in which, for various other purposes including income tax, significant relief was provided. These income

tax provisions are, by and large, extensions of the positive changes in income taxes which were swept into place in 2001 and 2002. A preservation of a 10% bracket rate for certain low-income taxpayers and a maximum tax bracket rate of 35% was reenacted.

Capital gains rates for long-term capital gains at a maximum rate of 15% for 2011 through 2012 as well as the preservation of the preferential 15% rate for qualified dividends was also preserved in the law.

Higher income taxpayers will have no loss of itemized deductions and personal exemptions due to phase-outs for 2010 and the elimination of the deduction phase-outs has been extended through 2012. Marriage penalty relief was also extended through 2012.

In addition, there were changes which reduced taxes going forward. Social security taxes were reduced from 6.2% to 4.2% for taxpayers during the year 2011. This adjustment also applies to Social Security tax for self-employed individuals where the rate is reduced from 12.4% to 10.4%. The legislation also increased the exemption amount used to adjust a taxpayer's AMT income. As a result, it is projected that 21 million households will avoid the alternative minimum tax. The \$1000 maximum childcare credit was extended through the year 2010 as well.

The American Opportunity credit which was restructured in 2009 legislation was continued and provides for a tax credit of up to \$2,500 for tuition and related expenses paid during any of the first four years of college. This credit, while not available to all taxpayers, can be significant for those taxpayers to whom it does apply. Education

savings account enhancements were also continued.

The Act also reinstated qualified charitable distributions for 2010 and 2011. Qualified charitable distributions let IRA owners who are age 70½ or older contribute

up to \$100,000 per year directly from an IRA account to the owner's choice of qualified charities with no federal tax consequences, provided certain limiting conditions are met.

All of these income tax provisions will have a substantial impact on taxpayers and provide for reduced income tax expense for the next two years. These provisions which have been reenacted for the next one or two years are likely to become part of a series of approximately 50+ provisions in the tax law which are referred to as Tax Extender provisions. They are referred to in this fashion because the provisions referenced by the label all are slated to sunset on or before December 31, 2012.

As is clear from some of the political events in January, we continue to live in an environment in which there is increasing instability and turbulence with respect to what the law will be going forward. The economic pressures created by the Great Recession, and the looming federal deficit will likely be the driver for change and most especially tax increases in years to come. In this chaotic landscape, income tax planning becomes more important than ever. We at Wolcott Rivers Gates can assist you in income tax planning which will help you to navigate the uncertainty and make effective decisions in the face of provisions which we expect will continue to be in flux.



This article has been authored by C. Arthur Robinson, II, Esquire, who practices in the areas of tax planning and reformation, tax sensitive transactions, estate planning and estate administration. Please call Mr. Robinson at 757-470-5551 if he can be of any assistance to you with the matters mentioned in these articles or any other matter in his areas of practice.

ESTATE TAXES - *continued*

it is now clear to estate planning professionals and to educated laypeople, that the structural instability in our system continues and is likely to continue for a significant period of time. The demands for revenue at the federal level as well as the political polarization ensure that we are likely to see changes in a number of tax regimes including the estate tax in years to come.

The second observation that flows from the 2010 Act is that we need to make changes to the way in which we plan for estates. It was common practice prior to 2001 to use relatively static formula funding provisions in estate planning documents for potentially taxable estates. The documents were designed to reduce, delay, or eliminate estate tax depending on the circumstances. Based on the interaction between the federal estate tax law and state statutes, this sort of formulaic approach which was widely used and would typically be used in virtually every case is no longer the optimum design. Rather, the optimum design in today's environment will depend upon the composition and overall scale of a taxpayer's estate as well as their objectives.

While a number of varying approaches suggest themselves, those approaches vary based on the parameters identified above. However, one key planning point should be emphasized for everyone, and that is that creating estate planning instruments that contain as much flexibility as possible. We also need as much ability on the part of trustees, executors, and administrators to make decisions after the fact, which will be critical in designing estate plans that are optimal in a changing and unstable environment. Techniques such as disclaimer funding, powers of appointment and trust decamping provisions (which enable the trustees and administrators to create different trusts for different intended uses which can be articulated by our clients) will become far more important than they have been before.

The third implication flowing from the Act is that for the next two years, for certain taxpayers, we will have a window of opportunity to do taxable gifts which is unprecedented in recent history. Potential gifts of up to

\$5 million will not be taxable, and because the gift tax exemption is as great as it is, the opportunity to make gifts to children and especially grandchildren are far more significant than they have been in recent years. While there are some uncertainties associated with these gifts, it is fair to say that the exemptions

in conjunction with standard advanced techniques, such as family limited liability entities, sales of interest to Intentionally Defective Grantor Trusts, and Grantor Retained Annuity Trusts, are all extremely attractive.

In addition, because of historically low interest rates, certain other techniques such as charitable lead annuity trusts, are more effective than they have been in living memory. The instability and the opportunity, as well as the uncertainty in which we are doing this planning all point to a call for action. In some cases, the action will be to increase the flexibility of existing plans. In other cases, real opportunities exist which may not be available after January 1, 2013.

The best advice we can give to all of our clients is that in our current circumstances, it is very important that estate plans be reviewed and appropriate adjustments be made to increase their flexibility and to take advantages of existing opportunities. We at Wolcott Rivers Gates can assist in this evaluation.

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