Personal Planning Strategies

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The 2010 Tax Act – What it Means for Your Current Will/Revocable Trust and Estate Plan

As we previously reported, The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “2010 Act”) made significant changes to the estate, gift and generation-skipping transfer (“GST”) tax regimes.

Increased Exemptions

Under the 2010 Act, each of the federal estate tax, GST tax and lifetime gift tax exemptions has been increased to $5 million as follows:

- In 2011 and 2012, there is a $5 million federal estate tax exemption (increased from $3.5 million in 2009) and a 35% top estate tax rate (decreased from 45% in 2009).
- In 2011 and 2012, there is a $5 million GST tax exemption (increased from $3.5 million in 2009) and a 35% top GST tax rate (decreased from 45% in 2009).
- In 2011 and 2012, the lifetime gift tax exemption is $5 million (increased from $1 million) and a 35% top gift tax rate (decreased from 45% in 2009).

Of paramount importance is the “reunification” of the gift and estate tax exemptions. Previously, in 2009, and in prior years, the gift tax exemption was capped at $1 million, while the estate tax exemption was as high as $3.5 million in 2009. Now the exemption has been “reunified” at $5 million so every individual can gift up to $5 million during life without paying gift tax.

The increased gift tax exemption of $5 million creates opportunities to make larger lifetime gifts, to leverage more assets through a variety of estate planning techniques (such as a sale to a grantor trust) and to shift income producing assets to individuals such as children or grandchildren who may be in lower income tax brackets and/or reside in states with a low income tax rate or no state income tax.

In order for married couples to take full advantage of the increased exemption amounts, each spouse should have at least $5 million of assets (other than retirement assets) in his or her own name. To accomplish this, some married couples may need to re-title certain assets so that ownership is held by only one spouse. In the case of a spouse or spouses who have significant retirement plan assets, special planning, including customized beneficiary designation forms, may continue to be necessary.

Portability

Another important change under the 2010 Act is the newly enacted system of portability. Under the 2010 Act, for the first time in history, a deceased spouse's unused estate and gift tax exemption is portable and can be used by the surviving spouse. Portability is intended to prevent families from incurring gift and estate tax that could have been avoided through proper estate planning. The following is an example of portability:

> Assume Husband and Wife each has $5 million of his or her own assets. Husband dies in 2011 leaving his entire $5 million to his Wife. There would be no federal estate tax imposed on the Husband's estate because of the unlimited marital deduction.
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> Assume upon Wife's later death, the $5 million she inherited from Husband has appreciated to $8 million, so that Wife's total estate is worth $13 million.
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> Portability allows Wife to use her $5 million estate tax exemption as well as Husband's $5 million estate tax exemption for a total estate tax exemption of $10 million. In this example, the Wife's total estate is worth $13 million. With portability, Wife has a $10 million estate tax exemption (her $5 million exemption and Husband's $5 million exemption) which results in only $3 million being subject to estate tax. Assuming a 35% estate tax rate, the federal estate tax due is $1,050,000.

Bypass Trust

Similar to portability, a bypass trust can be used to allow assets to “bypass” the federal estate tax that otherwise would be imposed when the second spouse dies. While portability may simplify estate planning and be useful to married couples who do not engage in proper estate planning, there are several advantages to using a bypass trust including protecting assets from creditors, sheltering the appreciation of assets from estate tax and ensuring that the assets are ultimately distributed to the first dying spouse’s intended beneficiaries. For example:

> Assume the same facts as above, except that Husband leaves his $5 million to Wife in a bypass trust rather than outright. The assets in the bypass trust are protected from Wife’s creditors and will ultimately pass to Husband’s children. On Husband’s death, no federal estate tax is due because of Husband’s $5 million estate tax exemption.
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> Assume upon Wife’s death, the $5 million in the bypass trust has appreciated and is worth $8 million. Since the assets are held in a bypass trust, the $8 million in the bypass trust is not subject to estate tax in Wife’s estate. Wife’s total assets for estate tax purposes is $5 million which means that the federal estate tax on her estate would be $0 since she can use her $5 million estate tax exemption. By using a bypass trust, Husband and Wife pay no federal estate tax obtain creditor protection for the assets held in trust and the assets remain in the bloodline.

How do these changes affect your existing Proskauer estate-planning documents?

The good news is that our estate-planning documents are drafted to be flexible and, in general, their overall structure remains unaffected by the increased exemption amounts.

Typically, our Wills and Revocable Trusts for a married couple are structured to include a bypass trust for the surviving spouse (discussed above) and GST tax-exempt trusts for their descendants upon the death of the surviving spouse so that both spouses can utilize their maximum federal estate tax and GST tax exemptions.

A GST tax-exempt trust is drafted so that an individual can pass the maximum amount of property that is exempt from the GST tax in trust tax-free from generation to generation. Generally speaking, the GST tax applies when a person transfers property to someone who is at least two generations younger than the transferor (or to a trust which eventually benefits such individual). The GST tax is designed to tax the transfer of property which effectively “skips” one or more intervening generations.

Our typical documents are drafted with formulas which allow the bypass and GST tax-exempt trusts to be funded with assets equal to the maximum tax exemptions applicable at the time of an individual’s death. These formulas adjust automatically if the amount of the tax exemption changes.

Accordingly, a typical Will or Revocable Trust which was signed before the 2010 Act would still be effective and the bypass trust and GST exempt trusts would be funded with the maximum exemptions now allowable. For example, suppose Husband and Wife had signed a typical Will in 2009 when the estate tax and GST tax exemptions were $3.5 million. If Husband died in 2009, the bypass trust for Wife would be funded with $3.5 million and would be exempt from GST tax. If Husband dies in 2011, the bypass trust would be funded with $5 million and would be exempt from GST tax.

Overall, the increased exemption amounts under the 2010 Act mean that trusts created under your Will or Revocable Trust may be funded with significantly more assets than was previously possible. In general, this is good news and allows you to protect more assets from estate and GST taxes.

There may be instances where you will want to update your documents because the new larger exemption amounts result in too much money passing to particular individuals. For instance, if your bypass trust was left directly to your children instead of your spouse, you may want to make sure that there are enough assets available to your spouse at your death. Additionally, if you are a married couple and live in a state with a state estate tax (mostly states in the northeast) and we drafted your documents before 2004, there may be provisions that should be added to your documents which could save state estate taxes at the death of the first spouse.

Please do not hesitate to call us so that we can review your documents and make sure that they are up-to-date and reflect your current wishes.

Tax Return Filings and Other Reminders

Gift Tax Returns for 2010 Gifts

Gift tax returns for gifts that you made in 2010 are due on Monday, April 18, 2011 (as Friday, April 15, is Emancipation Day); however, you can extend the due date to October 17, 2011 (since this year October 15 falls on a Saturday). In order to do so, you must timely file a request for an automatic extension of time to file your 2010 income tax return. That also extends the time to file your gift tax return.

Allocation of GST in 2010

If you created a trust in 2010, you should direct your accountant to elect to have your generation-skipping transfer ("GST") tax exemption either allocated or not allocated, as the case may be, to contributions to that trust. You may have heard that for 2010 the GST tax rate was zero and incorrectly assumed that you need not file a gift tax return in order to elect in or out of GST allocation for 2010 trusts. The GST tax was still applicable in 2010, albeit with a zero tax rate. Thus, it remains critical that you file your 2010 gift tax return and opt out of automatic allocations of GST exemption to trusts where all of the beneficiaries are two generations below you (known as "skip persons") and the property is intended to pass to them.

For instance, if you created a 2010 trust for your grandchildren, given the 2010 GST tax rate of zero, you would be wasting your GST exemption if any of it were allocated to that trust if the trust will not later pass to successively younger generations. Additionally, there may be instances where you will want to opt out of automatic GST exemption to trusts where the beneficiaries are your children and grandchildren (known as "indirect skips").

You should file a gift tax return for those purposes even if your gifts did not exceed the annual gift tax exclusion and, therefore, would not otherwise require the filing of a gift tax return. Please call one of our attorneys if you have any questions about your GST tax exemption allocation.

Make Sure that You Take Your IRA Required Minimum Distributions

If you are the owner of a traditional IRA, you must begin to receive required minimum distributions from your IRA and, subject to narrow exceptions, other retirement plans, by April 1 of the year after you turn 70 ½. After that, you must receive those distributions by December 31 of each year. So, if you turned 70 ½ during 2010, then you have until April 1, 2011 to take your RMDs. The RMDs must be calculated separately for each retirement account that you own, and you, not the financial institution at which your account is held, are ultimately responsible for making the correct calculations. The penalty for not withdrawing your RMD on time is an additional 50% tax on the amount that should have been withdrawn.

Please consult us if you need assistance with your RMDs.

2010 Conversions of Traditional IRAs to Roth IRAs

When you convert from a traditional IRA (which is funded with pre-tax dollars) to a Roth IRA (which is funded with post-tax dollars), the resulting income is reportable by you for income tax purposes with respect to the conversion year. However, for 2010 conversions, you can benefit from a special deferral arrangement whereby one-half of the converted amount is taxed in 2011 and the other half is taxed in 2012. This tax deferral benefit applies to 2010 conversions only.

You must report your 2010 IRA conversions on IRS Form 8606 that you will attach to your individual income tax return (or separately file, if you do not need to file an income tax return). Unless you elect out of the special 2010 benefit, the conversion income automatically will be spread over 2011 and 2012. You should, of course, compare your other 2010 income and deductions to those you anticipate having in 2011 and 2012 before you irrevocably default to the two-year deferral. Under certain circumstances, you may find it more advantageous to elect out of the automatic two-year spread and include all of the conversion income in 2010. You also may do that on Form 8606.

Unfortunately, if you converted more than one traditional IRA, you do not have the option of deferring the tax on one conversion but not another. It is an all-or-nothing election. However, you can choose different tax treatment if you both converted a traditional IRA to a Roth IRA *and* made an in-plan rollover from a traditional account to a Roth 401(k), Roth 403(b) or Roth 457(b) account. In that case, you are able to make different elections because you are required to file a separate Form 8606 to report conversions and rollovers. The filing of the separate forms enables you to make elections that relate specifically to all of your conversions or all of your rollovers, as the case may be, reported on each form.

Although this tax deferral provision will not be available for any 2011 IRA conversions, converting to a Roth IRA may still be advantageous, since assets in a Roth IRA grow tax-free and are not subject to required minimum distributions during your lifetime. That allows a Roth IRA to act as a “tax shelter” to hold wealth for your descendants if you have no need to make withdrawals during your retirement. More information on the benefits of a conversion to a Roth IRA may be found in the June 2009 issue of Personal Planning Strategies, available on our website.

Crummey Letters

If you transfer funds to an insurance trust (or another trust where a beneficiary has withdrawal powers), remember that when you make contributions to that trust, the Trustees should send “Crummey” letters to the beneficiaries to notify them of their withdrawal rights over the amount of your contribution to the trust. Without these letters, transfers to the trust will not qualify for the gift tax annual exclusion.

IRS Issues Informal Guidance on Basis Form Used When Opting out of the Federal Estate Tax in 2010

For deaths that occurred in 2010, the executor or personal representatives of the estate has the ability to opt out of the estate tax regime. This means that no federal estate tax would be due, but it may come at an income tax cost. When a person dies, the person's estate receives an income tax benefit in the form of a "cost basis adjustment." An individual who sells an asset at a gain will usually pay a tax on the gain. When an individual dies, however, any gain that may exist at the time of death is eliminated by a provision under the income tax laws that increases the cost of the assets to the person, called the person's "cost basis" in the asset, to the value at the time of the person's death. This is called a "step-up" in the cost basis, and it prevents the person's assets from being taxed both for estate tax and income tax purposes.

If you choose to opt out of the estate tax in 2010, then the "step-up" provisions also do not apply. Instead, every decedent is allowed a total of $1,300,000 in "step-up" adjustments which the decedent's executor can allocate to appreciated assets owned by the decedent at death. Such adjustments eliminate up to $1,300,000 of gain in the decedent's assets (the "basis adjustment amount"). For married individuals, property passing to the spouse (either outright or to a marital trust) is entitled to an additional $3,000,000 of basis adjustments for appreciated assets, which can effectively eliminate $4,300,000 of gain in the decedent's assets.

On February 16, the IRS issued informal guidance with regard to Form 8939, the federal tax form that will be used to report the cost basis of a decedent and allocate the step-up adjustments for the estates of decedents who died in 2010 and whose executor decides to elect out of the federal estate tax regime. Unofficial information from the IRS also indicates that Form 8939 will be used to make the election to opt out of the estate tax regime as well.

The guidance provides that Form 8939 will be issued at least 90 days before it is required to be filed. Clarification of the issuance of the form and the potential due date was needed in light of the uncertain due date for the form. Under one interpretation, Form 8939 would be due on the due date for the decedent's final income tax return, Monday, April 18 (as Friday, April 15 is Emancipation Day). It is unclear whether an extension of time to file a decedent's income tax return would also extend the due date for Form 8939. Under the alternative interpretation, Form 8939 would be due no sooner than 9 months after the enactment of the 2010 Tax Act. This would place the due date no sooner than Monday, September 19 (as Saturday, September 17 falls on the weekend). Regardless of which interpretation is ultimately adopted, executors can take comfort in knowing that the potential April 18 deadline will be pushed back until at least 90 days after the form is finalized.

The filing of Form 8939 and the decision of whether to elect out of the estate tax regime are complex matters that should be discussed with a qualified tax professional. Please contact us if you require our assistance.

Florida Appeals Court Holds that Husband and Wife Can Waive Homestead Rights Merely by Signing a Joint Deed – *Habeeb v. Habeeb*, 36 Fla. L. Weekly D300c (3rd DCA 2011)

Under Florida law, a married individual may not leave his or her principal residence to whomever he or she wishes at death (under Florida law the principal residence of a Florida domiciliary is known as a "homestead"); however, the homestead may be devised to the individual's spouse if the individual does not have any minor children. If the individual does have minor children, or if the individual does not have minor children *and* does not devise the homestead to his or her spouse, then, upon the individual's death, the spouse receives the right to live on the homestead for his or her lifetime (this is known as a life estate), and the individual's children (both adult and minor children) inherit the homestead upon the spouse's death.

The foregoing rule can be problematic when it is more desirable, for transfer tax planning purposes, for the homestead (or some portion thereof) to pass to someone other than the surviving spouse upon the death of the first spouse. For example, it may be desirable for the homestead to pass to a “bypass” or “credit shelter” trust for the benefit of the surviving spouse, so that the first spouse to die can take advantage of his or her Federal estate and generation-skipping tax exemptions (currently $5 million each), and so any appreciation on the homestead between the deaths of the spouses will not be included in the gross estate of the surviving spouse upon his or her death. Another example is where a division of the homestead between the spouses, *as tenants in common*, would allow each undivided portion of the homestead to qualify for a valuation discount upon the death of each spouse, which would save estate taxes.

To get around the restrictions on the devise of the homestead, either or both of the spouses can waive their right to inherit the homestead upon the death of the first spouse. (Note, however, that such a waiver is effective only if the first spouse to die does not have minor children at the time of his or her death.) Florida Statutes provide that a waiver of homestead rights can be accomplished before or after the marriage by a “written contract, agreement or waiver,” provided that, if the waiver is executed after the marriage, each spouse makes a “fair disclosure to the other of that spouse’s estate. . . .” Traditionally, the statute has been interpreted to require the spouses to agree to the homestead waiver in a written instrument separate and apart from any deed transferring the homestead. Furthermore, some practitioners have interpreted the statute as requiring the parties to make a full disclosure of their assets and liabilities.

In *Habeeb v. Habeeb*, Florida’s Third District Court of Appeal was faced with determining whether the husband waived his homestead rights merely by signing a deed which transferred the marital residence to the wife. In deciding an issue of first impression, the court held that a husband’s and wife’s signing of a deed to their homestead from husband and wife as tenants by the entireties, to the wife individually, by itself constituted a waiver of the husband’s homestead rights in the property upon the wife’s death.

In *Habeeb*, many years after signing the deed, the wife died with a Will purporting to devise a life estate in the homestead to the husband, and a remainder interest in the homestead to her sister. A few months later, the husband died, survived by his six nephews. A little more than one year later, the wife's sister died and was survived by her daughter (the wife's niece). Thus, the determination of whether the husband's homestead waiver was valid would determine whether the wife's niece or the husband's nephews would inherit the homestead.

First, in analyzing whether there had been fair disclosure, the court focused on the fact that (a) the spouses had been in a long-term marriage, (b) the spouses later prepared Wills based on the assumption that the deed effectively relinquished the husband's homestead rights (i.e., by the wife leaving a remainder interest in the homestead to her sister) and (c) the husband, after the wife's death, executed certain documents in connection with the probate of the wife's estate without contesting the devise of the homestead in the wife's Will. The court believed that these factors were proper grounds for determining that fair disclosure had been made.

The court then turned to whether the deed itself was sufficient to constitute a "written contract, agreement or waiver" as contemplated by the waiver statute. The court was not deterred by the fact that the word "waiver" did not appear in the deed, stating that ". . . 'waive' is not a talismanic word within the statute. . . ." The court also found that the statute did not require a *second* contract, agreement, or waiver—that is, a deed itself can constitute the requisite written contract, agreement or waiver. Accordingly, the court held that that the husband waived his homestead rights by signing the deed.

Thus, it appears that a husband and wife can waive their homestead rights in a joint deed without having to prepare a separate waiver instrument or making an explicit disclosure of their assets and liabilities. This is good news for those spouses who wish to waive their homestead rights to facilitate transfer tax planning—now all that is necessary is a valid deed. However, those spouses who want to transfer title to their homestead without waiving their homestead rights should proceed with caution, and probably should execute an agreement (or include language in the deed) expressly retaining their homestead rights.

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