December 20, 2010

Tax Legislation Provides Long-Awaited Transfer Tax Relief and Planning Opportunities

Introduction

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act") into law, extending the Bush tax cuts for another two years and providing long-awaited clarity with respect to the estate, gift, and generation skipping transfer ("GST") tax laws, at least for 2010, 2011, and 2012. Among other things, the Act offers greatly expanded estate, gift, and GST exemption amounts, reduced transfer tax rates, and a 0% tax rate for 2010 GST transfers, creating an optimum tax environment for transferring wealth to future generations.

While the Act temporarily cures the uncertainty that plagued estate planning initiatives in 2010, barring future Congressional action, the state of the law in 2013 and beyond remains unclear. Accordingly, those who wish to take advantage of the favorable tax rules may want to act within the two-year window. Furthermore, a unique opportunity exists for some during the balance of 2010, while the GST tax rate is 0%.

Estate Tax: Reinstatement, Flexibility for 2010, and Introducing "Portability"

Exemption Amount. The Act provides that a decedent who dies in 2010, 2011, or 2012 will have a $5 million exemption, a dramatic increase from the previous high level mark of $3.5 million in 2009. (Consistent with prior law, a decedent's estate tax exemption is reduced by the amount of any gift tax exemption used during his or her lifetime.)

Indexing. The estate tax exemption amount will be indexed for inflation, beginning in 2012.

Applicable Rate. The Act offers further relief by reducing the maximum estate tax rate to 35%.

Stepped-Up Basis. Assets transferred from a decedent's estate will receive a full step-up in basis to their fair market value at the decedent's death, as under the pre-2010 law.

Election for Decedents Dying in 2010. The estate of a decedent dying in 2010 may elect out of the reinstated estate tax regime, and instead may opt to apply the modified carryover basis rules. While no estate tax will be due, the step-up in basis available to the property

<u>IRS Circular 230 disclosure</u>: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter that is contained in this document.

transferred from a decedent's estate generally will be limited to $1.3 million, with an additional $3 million available with respect to transfers to a spouse or a trust for the spouse's benefit.

Portability. In a marked departure from prior law, the Act introduces the notion of "portability." Effective for decedents dying on or after January 1, 2011, the Act allows the estate of a surviving spouse to use any unused portion of the first spouse's estate tax exemption. As a result, married couples may shield up to $10 million from federal estate tax, even if the first spouse to die fails to utilize his or her exemption. Note, however, that a decedent's GST exemption amount will expire at death, and cannot be salvaged through portability.

Creating a trust to shelter the first spouse's available estate tax exemption nevertheless remains a prudent option. The trust not only provides asset protection, but also allows the appreciation earned on trust assets during the period between the first spouse's death and the second spouse's death to pass to the beneficiaries free of estate tax. Furthermore, because portability may expire at the end of 2012, there is the possibility that portability provisions may not exist at the death of the second spouse, creating the risk that the first spouse's unused exemption will be lost permanently.

Gift Tax: Increased Exemption, Unification and Lower Rates

Exemption Amount and Unification. The Act extends the generous estate tax benefits to lifetime gifts. Specifically, the Act unifies the estate and gift tax exemptions, bringing them both up to $5 million. While the $5 million estate tax exemption begins in 2010, the gift tax exemption rises to $5 million in 2011 (from $1 million in 2010). Consistent with prior law, a transferor's use of his or her gift tax exemption during life will correspondingly reduce the amount that he or she may pass at death free of estate tax.

Indexing. Like the estate tax exemption, the gift tax exemption amount will be indexed for inflation, beginning in 2012.

Applicable Rate. Gifts made in excess of a transferor's exemption amount will be subject to tax at a rate of 35%, an extension of the 2010 rate and a marked reduction from the 45% rate that applied in 2009.

GST Tax: Increased Exemption, Lower Rates, and a Rare Opportunity in 2010.

Exemption Amount. The Act provides that, with respect to GST transfers made in 2010, 2011 and 2012, the GST tax exemption amount will be $5 million.

Indexing. The exemption amount will be indexed for inflation, beginning in 2012.

Applicable Rate for 2011 and 2012. The Act sets the maximum GST tax rate, for 2011 and 2012, at 35%.

Generation-Skipping Transfers in 2010. Generation-skipping transfers made in 2010 are not exempt from GST tax. However, because the applicable tax rate for 2010 generation-skipping transfers is 0%, no GST tax will be payable on such transfers. In order to take advantage of this unique opportunity, there must be a generation-skipping transfer event in 2010 and an election to opt out of the automatic allocation of GST exemption. By opting out of the automatic allocation, the GST exemption amount can be preserved for planning future years (when the GST tax rate is set to increase).

Generation-Skipping Transfers in 2010 to Trusts. Gifts made in 2010 to trusts exclusively for grandchildren (and more remote descendants) will not trigger GST tax in 2010 (due to the 0% GST tax rate) or in any later year when distributions from such trusts are made to grandchildren. (The transfer into the trust, however, may give rise to a gift tax.) Assuming the trust is not GST tax-exempt due to allocation of GST exemption, post-2010 distributions to more remote descendants will trigger GST tax.

Generation-Skipping Transfers in 2010 from Trusts. Distributions in 2010 from trusts that otherwise would attract a GST tax will not trigger a tax. As an example, consider the case of an existing discretionary trust for children and more remote descendants which often follows a successful grantor retained annuity trust, or GRAT. Distributions from such trusts to grandchildren, absent the unusual 2010 tax law, normally would come at the hefty cost of the GST tax. However, until the end of the year, the tax rate for such generation-skipping distributions will be zero. Such distributions may be made outright or in further trust.

Extension for Filing Returns

The Act, in recognition of the administrative pratfalls that accompanied the uncertainty of the law in 2010, grants an extension for filing estate and GST tax returns. For 2010 decedents who die prior to the enactment of the Act, and for 2010 GST transfers made prior to enactment, the deadline for filing a return, and paying estate taxes, is nine months from the date of enactment of the Act.

Silence Is Golden: GRATs and Discounts Unaffected

GRATs. Despite recent attempts by Congress and the Obama administration to limit the use of short-term GRATs with nominal taxable gifts, the Act does not address GRATs in any way. As a result, the GRAT remains a powerful estate planning tool, and can be particularly effective in the current low-interest environment.

Discounts. Valuation discounts have played an important role in minimizing transfer tax liability, particularly with respect to transfers of illiquid and minority interests in entities. There was speculation that the Act would limit the ability to value interests with discounts for lack of control and marketability in some instances. However, the Act is silent on this issue.

Sunset Provisions

The provisions of the Act sunset at the end of 2012. As such, without future Congressional action, 2013 will usher in the return of higher transfer tax rates and slashed exemption amounts.

What Now? Planning Opportunities

Gifts and Distributions to Grandchildren in 2010. The provisions of the Act create the singular opportunity to transfer substantial assets (in excess of $5 million) to grandchildren and more remote descendants without incurring GST tax. While gifts in excess of the 2010 $1 million gift tax exemption (to the extent unused) would be subject to gift tax at the 35% rate, the tax on such gifts would not be compounded by an additional GST tax. Furthermore, trust distributions to grandchildren could be made in 2010 without gift or GST tax if the trust property already is outside the individual's estate.

Gifts in 2011 and 2012. The Act creates an opportunity for clients who already have used their $1 million gift exemption to make additional substantial gifts without gift tax exposure. Beginning on January 1, 2011, taxpayers will be able to make aggregate lifetime gifts of up to $5 million (less prior taxable gifts which reduced the exemption) without incurring any gift tax.

The Act creates compelling estate planning opportunities worthy of exploration. We welcome the opportunity to discuss these issues with you.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

John J. O'Neil	Alan S. Halperin
212-373-3379	212-373-3313
joneil@paulweiss.com	ahalperin@paulweiss.com

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410