WILLMS, S.C.

LAW FIRM

# MEMORANDUM

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**TO:** Clients and Friends of Willms, S.C.

**FROM:** Andrew J. Willms

**Date:** January 6, 2011

**SUBJECT:** Estate Planning After the 2010 Tax Act

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As we have previously reported to you, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Tax Act") made significant changes to the estate, gift, and generation-skipping transfer tax provisions of the Internal Revenue Code. Effective January 1, 2011 the new law increases the federal gift tax exemption (which shelters lifetime gifts in excess of the annual exclusion from the federal gift tax), the federal estate tax exclusion (which shelters transfers at death from estate taxes) and the generation-skipping transfer tax exemption (which can protect transfers to grandchildren and more remote descendants from the generation-skipping transfer tax) from $3,500,000 to $5,000,000.

Under prior law, all three of these were to be only $1,000,000 on January 1, 2011. As a result, it was quite common for estate plans of married persons to be prepared such that when the first spouse died an irrevocable trust was established for the benefit of the surviving spouse. The purpose of the irrevocable trust was to make sure the estate tax exclusion of the first spouse to die was not wasted.

In other words, the estate tax exclusion of the first spouse to die can be used to transfer assets to an irrevocable trust free from estate taxes. Moreover, even if the surviving spouse is entitled to all of the irrevocable trust income and trust principal as needed for health,

support and maintenance, and even if the surviving spouse is the sole trustee of the irrevocable trust, assets transferred to the irrevocable trust when the first spouse dies are not subject to estate taxes at the death of the second spouse.

Under the 2010 Tax Act, it may no longer be necessary to transfer assets to an irrevocable trust when a married person dies. The new law allows any estate tax exemption not used by the estate of the first spouse to die to be transferred to the surviving spouse. As a result, if the 2010 Tax Act remains in effect a marital estate of $10,000,000 or less will avoid estate taxes even if the first spouse to die leaves his or her assets outright to the surviving spouse. However, an estate tax return will need to be filed upon the death of the first spouse to obtain this result.

In fact, if the combined net worth of both spouses is under $10,000,000, the transfer of assets to an irrevocable trust when the first spouse dies could prove to be disadvantageous from an income tax perspective under the new law, because the new law also resurrected the income tax basis "step up" rules.

As a result of the 2010 Tax Act, inherited property with built-in capital gains once again receives a step up in basis for income tax purposes. Tax basis for the person who inherits the property is increased (or decreased) to the property's fair market value at the date of death. However, property placed in an irrevocable trust when the first spouse dies will not receive a basis step up when the second spouse dies. Therefore, children or other heirs could pay less income tax when they ultimately sell inherited assets if all assets belong to the second spouse to die and are not in an irrevocable trust.

Making things even more complicated is the fact that the above described provisions of the 2010 Tax Act expire on December 31, 2012 unless changes to the law are made before then. Therefore, taxpayers are once again required to try to plan for the disposition of their assets at death without knowing what the tax rules will be at that time.

It is yet undetermined what effect subsequent laws might have on the current tax provisions. For example, what happens if an individual takes advantage of the lifetime gifting exemption by gifting $4 million in 2011, and then in 2013 the exemption is only $3.5 million? It is possible the gift tax avoided during lifetime could be recaptured in the form of some estate tax at death.

The good news is that we have developed ways to make our estate planning documents flexible. We can add provisions to your estate plan that will allow your estate plan to be adapted to the laws that exist when your estate plan takes effect. These provisions could prove to be very beneficial to married persons whose combined net worth exceeds $2,000,000. Please call to schedule an appointment if you would like to discuss the possibility of adding such provisions to your estate plan.

END OF MEMO