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The New Federal Estate and Gift Tax Rules: Do I Really Need an Estate Plan Anymore?

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Recent legislation significantly changed the federal transfer tax rules (which govern the taxation of gifts and estates). In light of these changes, many have questioned whether estate planning remains a necessity for the average person. This article summarizes the new transfer tax rules and highlights the reasons – tax- and non-tax-related – that planning remains as relevant as ever.

Summary of the New Federal Transfer Tax Rules

The following summarizes how the federal estate, gift, and generation-skipping transfer ("GST") taxes apply under the new transfer tax rules.

- **Estate Tax.** The estate tax exemption has been increased so that the first $5,000,000 of a decedent's estate will pass free of any tax. Absent an applicable deduction, assets in excess of the exemption amount will be subject to federal estate tax at a 35% rate. In addition, the unlimited marital and charitable deductions still apply, meaning that assets left to a surviving spouse or charity will not generate any estate tax.

  North Carolina imposes its own tax on estates. Because North Carolina's tax is tied to the federal rules, the value to be taxed will be the same value determined under the federal rules, to which North Carolina then will apply its own rate.

- **Gift Tax.** The gift tax exemption has been increased to match the estate tax exemption, meaning that individuals can make up to $5,000,000 in lifetime gifts without the imposition of tax. Those lifetime gifts, however, will reduce, approximately dollar-for-dollar based on certain calculations that must be performed, the amount that can be left estate tax-free at death. Gifts in excess of the exemption will be subject to tax at a 35% rate.

  North Carolina no longer applies a tax on gifts.

- **GST Tax.** The GST tax, which is imposed on certain transfers benefiting generations more than once removed from that of the transferor, will apply at a 35% rate. The tax, however, applies only to GST transfers in excess of the $5,000,000 lifetime exemption.

  North Carolina does not impose a GST tax.

- **Portability of Estate and Gift Tax Exemptions.** If a spouse dies during the effective period of the

new legislation, the deceased spouse's unused gift and estate (but not GST) tax exemptions can be added to the surviving spouse's exemptions. To make use of these "portability" provisions, the estate of the first spouse to die must make the requisite election on a timely-filed estate tax return.

The new transfer tax rules and exemption amounts (which are indexed for inflation) potentially exempt all but the wealthiest individuals from taxation and offer the opportunity to simplify estate plans. Absent extension legislation, however, these rules will expire at the end of 2012, and much less taxpayer-friendly rules will apply thereafter.

The Continued Relevance of Estate Planning

Despite the increased exemption levels and "portability" provisions available in 2011 and 2012, estate planning, for estate tax reduction and other important reasons, remains a critical process for almost everyone.

- **Important Non-Tax Considerations.** Estate planning is more than a set of documents driven by tax considerations. The process ideally involves a careful consideration of personal and family goals, followed by the development of a comprehensive strategy to ensure that those goals are met. In most cases, implementation of that strategy should include execution of documents that give legal effect to the desired distribution plan; reaffirm or revise beneficiary designations for life insurance and retirement accounts to integrate those assets into the plan; and take into consideration various tools to simplify, keep private, and reduce the costs (tax and otherwise) that otherwise could be associated with the overall estate administration process. A well-conceived plan also should prepare for the individual's incapacity by designating agents for decision-making and providing advanced directives for end-of-life decisions. These issues are relevant to everyone, regardless of wealth, and should be addressed appropriately, for the peace of mind not only of the individual, but also of that individual's family and caregivers.
- **Trust Us; Trusts Can Be Good.** Under the previous federal (and, by adoption, North Carolina) transfer tax rules, an irrevocable trust was often included in spouses' estate plans for the benefit of the surviving spouse. The trust was funded with an amount up to the estate tax exemption and, if designed properly, was not subject to estate tax in the surviving spouse's estate. Such an arrangement allowed assets valued up to the total of both spouses' individual estate tax exemptions to pass estate tax-free at the death of the surviving spouse.

  Due to the new "portability" rules, a married couple theoretically no longer has to utilize trusts to achieve that result – the first-to-die spouse's unused exemption amount is simply added to the surviving spouse's available exemption amount. Therefore, some commentators have concluded that portability eliminates the need for trusts in estate planning. They suggest instead that "survivor wills" – which leave all assets outright to the surviving spouse – are appropriate in every instance.

  Such a rationale, however, ignores numerous non-tax-related protections that a trust can provide. For example, creditors of the surviving spouse cannot gain access to the assets of a properly designed trust. Also, if the surviving spouse becomes incapacitated, a trust can provide continuity of management and protection against exploitation. Finally, because a trust typically dictates distribution after the surviving spouse dies, it protects against the possibility of a remarriage resulting in a subsequent disinheritance of intended beneficiaries.

  Important tax considerations also remain that may make a trust for the surviving spouse an

appropriate option. For example, portability does not apply to the GST exemption. Therefore, individuals who want to maximize generational-type planning should still strongly consider a trust arrangement. Also, the assets of a trust for the benefit of the surviving spouse and all appreciation in the value of those assets will escape estate taxation at the death of the surviving spouse. The appreciation associated with assets received outright, however, is fully subject to estate taxation, even if portability is available.

Including trusts in an estate plan for non-spouse beneficiaries remains an important option as well. In addition to the asset protection benefits discussed above, trusts also can serve to maintain the underlying assets until the beneficiary is sufficiently mature to handle financial responsibility. Trusts also can protect eligibility for government benefits in the event that the beneficiary is disabled.

- **What Will Congress Do?** Although the new transfer tax rules can be of great benefit for taxpayers, they apply only through 2012. Congress has tinkered with these rules repeatedly over the last 20 years, but has shown little consistency in its approach to changes. Therefore, failing to plan for a potential return to less advantageous rules may be short-sighted. In light of this uncertainty, it may be wise to establish an estate plan that is flexible enough to allow a surviving spouse to make choices regarding the tax issues after the death of the first spouse and based on the law in effect at the time the choices are made.
- **Don't Look A Gift-Horse In The Mouth.** For many, a combination of factors (including the increased gift tax exemption, the current low interest rate environment, the current depreciated value of assets, and the acceptance by the IRS of certain "discounting" methods) makes numerous lifetime planning techniques especially attractive and tax efficient. Rather than pondering what might be in the future, acting on the conditions and available tax breaks of the present might achieve significant benefits.

Conclusion

The new transfer tax rules undoubtedly offer the possibility of significant tax relief. Numerous factors, however, suggest that estate planning remains a worthwhile and relevant process. Careful consideration of relevant factors – both tax- and non-tax-related – remains essential to achieving planning goals.

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For further information regarding the issues described above, please contact Carrie B. Cline or Matthew W. Thompson.

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