



The Tax Relief Act of 2010: Impact on the Federal Estate, Gift, and GST Taxes

Foster Swift Estate Planning Bulletin

December 2010

PRACTICE AREAS

Estate Planning

On Friday, December 17, 2010, President Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." Under the Tax Relief Act of 2010, the federal estate tax, which disappeared for 2010, springs back to life in 2011 and is imposed at the top rate of 35% on the value of an estate in excess of \$5 million. This Bulletin provides a brief overview of the federal estate, gift, and generation skipping transfer tax aspects of the new law.

BACKGROUND

The modern estate tax dates back to 1916, when it was imposed at a rate of 10% on the portion of estates above \$50,000. Over the years, the rates and exclusion amounts have varied, reaching the highest levels from 1941 to 1976 with a top rate of 77% and a \$60,000 exclusion amount.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the first of the two large legislative packages that contain most of what are now commonly referred to as the "Bush tax cuts." EGTRRA gradually lowered the maximum estate tax rate and substantially raised the exclusion amount over the years 2002 through 2009. EGTRRA completely repealed the estate tax for decedents dying in 2010. The repeal led to several well-publicized instances in which wealthy individuals died in 2010 leaving multibillion-dollar estates that will pass to their heirs without paying any federal estate tax.

All of the provisions of EGTRRA were scheduled to sunset on December 31, 2010, meaning that, if Congress had not acted, then starting January 1, 2011, the estate tax would have reverted back to the 2001 level. Thus, the exclusion amount would have been only \$1 million per individual, a significant reduction compared to the 2009 exclusion amount of \$3.5 million per individual. In addition, the estate tax rate would have risen to a top rate of 55% in 2011, an increase from a top rate of 45% in 2009.



NEW LAW

Under the new law, the estate tax returns at a lower rate and a higher exclusion amount than scheduled under EGTRRA's sunset provision, at least for 2011 and 2012. During 2011 and 2012, the top estate tax rate will be 35%. For 2011, the exclusion amount will be \$5 million per individual (indexed for inflation after 2011). At those levels, in 2011, only an estimated 3,500 decedents' estates nationwide will be subject to any federal estate tax, and the tax will raise about \$11.4 billion for the government. By way of comparison, the scheduled 55% tax with a \$1 million exclusion would have subjected about 43,540 decedents' estates to federal estate tax in 2011, and would have raised about \$34.4 billion. Except for the temporary repeal of the estate tax in 2010, the estate tax rate has not been less than 45% since 1931.

The new law gives the estate of a decedent dying in 2010 the choice between (1) a federal estate tax with a \$5 million exclusion, a 35% top rate, and a "step-up" in basis to fair market value on death, or (2) no federal estate tax and a modified carryover basis. The estate tax and basis changes under the first option, by default, are effective retroactively for estates of decedents dying after 2009. However, the executor of the estate of a decedent dying in 2010 may elect to have no federal estate tax and a modified carryover basis.

This is important because inherited assets with low basis in relation to the value at the decedent's date of death may expose the heir to significant capital gains tax at the time of sale under the modified carryover basis rules. The modified carryover basis rules assign inherited assets a tax basis equal to the price the decedent paid at the time of purchase rather than the value at the decedent's death. That could lead to a heavy tax burden for heirs who sell inherited assets such as stocks that were held for many years and have greatly appreciated in value. By contrast, under the default option, heirs will be allowed to inherit assets with a "step-up" in basis to the asset's value at the decedent's death. For estates of decedents dying in 2010 with a taxable estate of \$5 million or less, the estate should be better off under the default option of subjecting the estate to a federal estate tax and receiving a "stepped-up" basis.

Beginning in 2011, the gift tax will be reunified with the estate tax. This means that the \$5 million estate tax exclusion will also be available for lifetime gifts. The law in effect prior to 2010 provided a \$3.5 million estate tax exclusion for estates, but only a \$1 million lifetime gift tax exclusion. The gift tax rate, starting in 2011, will also be 35%.

The exclusion from the generation-skipping transfer tax (GST tax) – the additional tax on gifts and bequests to grandchildren when their parents are still alive – will also rise to \$5 million from the \$1 million it would have been without the new law. The GST tax rate for transfers made in 2011 and 2012 will be 35%.

ESTATE PLANNING UNDER THE NEW LAW

From a planning standpoint, a nice feature of the new law is that the exclusion is "portable" between spouses. This means that if proper elections are taken, the unused portion of the deceased spouse's exclusion is transferred to the surviving spouse, which will be available at the surviving spouse's death in addition to the surviving spouse's exclusion amount. Under prior law, if the first spouse to die did not exhaust his or her exclusion, it was in effect "wasted" and was not available to the surviving spouse.



For most clients, the new law will not require a change to their estate plan but merely reduces their potential federal estate tax liability. However, for clients with significant wealth, planning opportunities may arise under the increased exclusion amount and decreased tax rates in 2011 and 2012. In particular, the increase in the lifetime gift tax exclusion offers the possibility of making lifetime gifts of up to \$5 million (less taxable gifts made in prior years) in 2011 or 2012, to take advantage of the increased exclusion amount if Congress does not extend the new law beyond 2012.

We hope this information is helpful. If you would like more details about the federal estate tax, gift tax, GST tax, or any other aspect of the Tax Relief Act of 2010, please contact a Foster Swift estate planning attorney.

