

Estate and Gift Tax Update

Among other things, the 2010 Tax Relief Act, signed on December 17, 2010, provides several areas of relief and tax planning opportunities for estate and gift taxes. Below is a summary of the major estate and gift tax provisions that, if utilized, could potentially reduce future estate and gift taxes and increase beneficiary inheritances.

Overview of the New Law

The 2010 Tax Relief Act provides temporary relief for 2010 through 2012. First, it reduces estate, gift and generation-skipping transfer (GST) taxes for 2011 and 2012. Secondly, it preserves estate tax repeal for 2010, but in a roundabout way: estates wanting zero estate tax for 2010 must elect that option, along with the less favorable modified carryover basis rules that were set to apply for 2010. Otherwise, by default, the estate tax is revived for 2010, with a \$5 million exemption, a top tax rate of 35%, and a step-up in basis. Lastly, for estates of decedents dying after Dec. 31, 2010, a deceased spouse's unused exemption may be shifted to the surviving spouse. However, please note that these generous rules are temporary — much harsher rules are slated to return after 2012.

Lower Rate and Higher Exemption for 2011 and 2012

For estates of individuals dying in 2009, the top estate tax rate was 45% and there was a \$3.5 million exemption. The top rate was to rise to 55% for estates of individuals dying after 2010, and the exemption was to be \$1 million. For 2011 and 2012, the 2010 Tax Relief Act reduces the top rate to 35%. It also increases the exemption to \$5 million for 2011 with a further increase for inflation in 2012. After 2012, the top rate will revert to 55%, and the exemption will be \$1 million.

Special Tax Saving Choice for 2010

As discussed above, the 2010 Tax Relief Act allows estates of decedents who died in 2010 to choose between (1) estate tax (based on a \$5 million exemption and 35% top rate) and a step-up in basis, or (2) no estate tax and modified carryover basis. Basis is the yardstick for measuring income tax gain or loss when an asset is sold. With a step-up in basis, pre-death gain is eliminated because the basis in the heir's hands is increased to the date of death value of the asset. On the other hand, with a modified carryover basis, the heir generally receives the decedent's original basis. Thus, if the decedent had a relatively low basis and significant assets, some pre-death gain may be taxed when the heir sells the property. These concerns factor into the special choice for 2010. The executor should decide which option would produce the lowest combined estate and income taxes for the estate and its beneficiaries. This would depend, among other factors, on the decedent's basis in the assets immediately before death and how soon the estate beneficiaries may sell the assets.

Gift tax and GST tax changes

Years ago, the gift tax and the estate tax were unified—they shared a single exemption and were subject to the same rates. This was not the case in recent years. However, for gifts made after Dec. 31, 2010, the gift tax and estate tax are reunified and an overall \$5 million exemption applies.

The GST tax is an additional tax on gifts and bequests to grandchildren when their parents are still alive. The 2010 Tax Relief Act lowers GST taxes for 2011 and 2012 by increasing the exemption amount from \$1 million to \$5 million (as indexed after 2011) and reducing the rate from 55% to 35%.

NEW RATES AND EXEMPTIONS UNDER TAX RELIEF ACT OF 2010				
As of January 1,	2010	2011	2012	2013
Top income tax rate	35%	35%	35%	39.6%
Capital gains tax rate	15%	15%	15%	20%
Qualified dividend tax rate	15%	15%	15%	39.6%
Social Security payroll tax rate	6.2%	4.2%	6.2%	6.2%
Estate tax rate	35%	35%	35%	55%
Estate tax exemption	\$5mm	\$5mm	\$5mm*	\$1mm
Gift tax rate	35%	35%	35%	55%
Gift tax exemption	\$1mm	\$5mm	\$5mm*	\$1mm
GST tax rate	0%	35%	35%	55%
GST tax exemption	\$5mm	\$5mm	\$5mm*	\$1mm*

*To be adjusted for inflation
Source: J.P. Morgan

New portability feature

Under the 2010 Tax Relief Act, any exemption that remains unused as of the death of a spouse who dies after Dec. 31, 2010 and before Jan. 1, 2013 is generally available for use by the surviving spouse in addition to his or her own \$5 million exemption for taxable transfers made during life or at death. Under prior law, the exemption of the first spouse to die would be lost if not used.

Conclusion

The estate tax relief in the new law is substantial, but it is temporary. Estate planning to reduce taxes remains an important consideration. The increase of the lifetime gifting exemptions allows taxpayers to reduce their estate by making significantly larger transfers than they could have in the past without incurring gift tax. Even if taxes are not a concern because an estate is below the exemption level, it is important to have a proper estate plan to ensure that the needs of intended beneficiaries are met.

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