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## 2010 Tax Relief Act - *Estate, Gift and Generation-Skipping Tax Changes*

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Craig G. Dalton Jr.

This Alert summarizes the changes recently made to federal estate, generation-skipping and gift tax laws under the 2010 Tax Relief Act. A chart summarizing the effects of the new law for 2010 through 2013 is included below.

### **Background**

Under the provisions of a prior Tax Act adopted in 2001, the estate, gift and generation-skipping taxes were substantially changed during the period from 2001 through 2010, including increases in the estate tax exemption and reductions in the estate and gift tax rates. The changes made by the 2001 Act culminated in a one-year repeal of the federal estate tax for decedents dying in 2010 but with the requirement that the tax basis of assets of a decedent dying in 2010 be carried over to the beneficiaries of the estate, subject to some adjustments. The 2001 Act did not repeal the gift tax; thus, it continued in 2010.

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## Summary of 2010 Tax Relief Act

**Decedents Who Died in 2010.** The 2010 Tax Relief Act allows estates of decedents who died in 2010 to choose between (1) an estate tax based on a \$5 million exemption and a 35% top estate tax rate and a step-up in tax basis; or (2) no estate tax but with a carryover tax basis for assets, with some modifications. Tax basis is the yardstick for measuring gain or loss when an asset is sold by the beneficiaries. With a step-up in basis, pre-death gain is eliminated because the tax basis in the heir's hands is increased to the asset's value on the date of death. With a carryover basis, the heir only takes the decedent's original basis subject to certain basis increases, which may be significant.

**Federal Estate Tax Exemption and Tax Rates for 2011 and 2012.** The new law increases the federal estate tax exemption for each taxpayer to \$5 million and decreases the federal estate tax rate to 35% on the value of the estate above the exemption amount. For a married couple, this means a combined total of \$10 million may pass estate tax free to their heirs. However, the \$5 million death tax exemption only applies to deaths occurring in 2011 and 2012. In 2013, unless Congress extends the law, the estate tax exemption is scheduled to revert to \$1 million per taxpayer with a estate tax rate of 55% on the excess.

**"Portability" of Unused Estate Tax Exemption.** The new law includes a provision referred to as "portability." If the first spouse to die does not have sufficient assets to claim his or her entire estate tax exemption, then the unused exemption may be transferred to the decedent's surviving spouse. However, portability applies only to deaths occurring in 2011 and 2012. The law is unclear whether the unused exemption is portable if the second spouse dies after 2012. Also, portability is not automatic. The estate of the first decedent must file a federal death tax return to permit the transfer of

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the unused death tax exemption to the surviving spouse. In addition, the second spouse's remarriage could affect the use of the decedent's unused exemption.

Federal Generation-Skipping Transfer Tax Exemption for 2011 and 2012. The federal generation-skipping transfer tax ("GST") exemption is also increased to \$5 million per taxpayer in 2011 and 2012. However, the GST exemption is not portable. Each spouse must claim his or her full GST exemption during life or at death, and any unused portion of a spouse's GST exemption will be lost. In addition, the GST exemption is scheduled to revert to \$1 million per taxpayer in 2013 unless Congress acts.

Federal Gift Tax Exemption for 2011 and 2012. The lifetime federal gift tax exemption is increased to \$5 million per taxpayer, and it is now portable. However, the increase of the lifetime gift tax exemption and its portability between spouses expires in 2013 when the exemption is scheduled to revert to \$1 million per taxpayer without portability unless Congress acts. Special strategies may be required to secure the benefits of the increased lifetime gift tax exemption in 2011 and 2012. Also, the gift tax exemption is unified with the death tax. A taxpayer's use of the gift tax exemption during lifetime reduces the estate tax exemption available at death. There is an anomaly in the law that could result in higher estate taxes if the decedent prior to death makes gifts of \$5 million and later the estate tax exemption is reduced. However, this was not the intent of Congress and this result will likely be corrected.

Federal Estate, Gift and Generation-Skipping Transfer Taxes After 2012. It is not clear what Congress will do with respect to the estate, gift and generation-skipping transfer taxes for years after 2012. Without any action, the laws will revert to the status they

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had under the law in effect prior to the 2001 Tax Act, that is (i) a \$1 million estate tax exemption with a maximum estate tax rate of 55%; (ii) a \$1 million gift tax exemption with a maximum 55% gift tax rate; (iii) a \$1 million generation-skipping transfer tax exemption; (iv) a 55% tax rate; and (v) no portability of the unused estate and gift tax exemption between the first spouse to die and the surviving spouse.

### **Estate and Gift Planning For the Next Two Years and Beyond**

2011 Tax Act Changes Not Permanent, So Far. The changes made by the 2010 Tax Relief Act apply to gifts made and decedents dying in 2011 and 2012. At this point, it is not clear whether Congress will extend those changes beyond 2012.

Estate Planning Documents. Many estate planning documents include formula provisions to make use of the estate tax exemption by funding a family bypass trust equal to such exemption, with the remainder outright to the surviving spouse or to a marital trust for the benefit of the spouse. With a \$5 million exemption, depending on the size of the decedent's estate, all or a substantial portion of the estate would be used to fund the family trust, with no remainder to pass to the surviving spouse or to a marital trust. Wills or revocable trusts that contain formulas based on the estate tax exemption should be reviewed by clients to see if such provisions need to be modified.

For those clients who do not anticipate having an estate in excess of the estate tax exemption (whether it is \$5 million, or if Congress later reduces the exemption, \$3.5 million or less), they might consider simply bequeathing all the estate to the spouse but allowing the spouse to disclaim assets to a family trust after the death of the client if

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necessary to save estate taxes. This alternative provides simplicity but, unless the spouse disclaims, it forgoes the advantages of a family trust: protection from the beneficiary's creditors and assurance that at the death of the surviving spouse the trust assets will pass to children or other persons whom the client desires to benefit rather than leaving that decision to the surviving spouse. This may be particularly important in the case of second marriages.

**Gift Planning.** The substantial increase in the gift tax exemption to \$5 million with a low gift tax rate for gifts in excess of that amount presents a unique opportunity to make large transfers during the clients' lifetime, such as to family members. The 2010 Tax Act also did not prohibit the use of valuation discounts when making gifts of assets such as interests in family partnerships and limited liability companies. The combination of the \$5 million gift tax exemption, relatively low gift tax rates, and valuation discounts make intra-family transfers even more beneficial. The federal GST exemption has also been increased to \$5 million for 2011 and 2012. Where wealthy clients desire to benefit grandchildren through direct gifts or generation-skipping trusts, the increased gift tax and GST exemptions present a unique opportunity to transfer significant assets to such persons. As discussed above, it is not clear whether the \$5 million gift tax and GST exemption will continue after 2012. It is also possible that Congress may prohibit the use of valuation discounts. Thus, clients should consider whether to take action while such beneficial provisions remain in the law.

**Estate Planning is Not Simply About Taxes.** Estate planning is not simply about taxes; it is about how to achieve your goals for the distribution of your assets in an orderly manner that provides for the support of your spouse, children, and perhaps grandchildren, protection of minors and those who have special needs, protection of a beneficiary's inheritance from creditors, in-laws and third parties, and assuring that your

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financial and social philosophy will continue to be implemented through the management of your assets after you pass away. The Trusts and Estates Section of Poyner Spruill LLP remains ready to help you achieve your goals.

**Federal Estate, Gift and Generation Skipping Transfer Tax: 2010 – 2013**

	2010	2011	2012	2013
Estate Tax	1. \$5 Million exemption, 35% tax rate on excess, stepped-up income tax basis, or elect  2. No estate tax and carryover basis  No Portability	\$5 Million exemption, 35% tax rate on excess, stepped-up income tax basis  Portability	\$5 Million exemption, (inflation indexed), 35% tax rate on excess, stepped-up income tax basis  Portability	\$1 Million exemption (not inflation indexed), 55% tax rate on excess, stepped-up income tax basis  No Portability

Gift Tax	\$ 1 Million exemption, 35% tax rate on excess  No Portability	\$5 Million exemption, 35% tax rate on excess, carryover income tax basis  Portability	\$5 Million exemption, (inflation indexed), 35% tax rate on excess, carryover income tax basis  Portability	\$1 Million exemption (not inflation indexed), 55% tax rate on excess, carryover income tax basis  No Portability
Generation-Skipping Transfer Tax	\$5 Million exemption, zero tax rate on excess (essentially unlimited exemption)  No Portability	\$5 Million exemption, zero tax rate on excess (essentially unlimited exemption)  No Portability	\$5 Million exemption, (inflation indexed), 35% tax rate on excess	\$1 Million exemption (inflation indexed) and 55% tax rate on excess
Annual Gift Tax Exclusion	\$13,000	\$13,000	\$13,000 (inflation indexed)	\$13,000 (inflation indexed)

## Comments

1. New provisions potentially subject to modifications by technical corrections acts.
2. Deceased Spouse's Unused Exclusion Amount ("portability") is not indexed for inflation.
3. Allocation of GST exemption is elective. Taxpayer may elect to pay GST tax on current gift and allocate GST exemption on later gifts or at death.
4. North Carolina follows federal rules. South Carolina has no estate tax in 2011 and 2012.
5. Estate and gift tax exemptions are unified. Lifetime exemption gifts reduce amount of death tax exemption available at death.



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