Estate Taxes On the Rise?

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2010 has been a very interesting year in the federal estate tax arena, as it marks the first year in nearly a century that a federal estate tax has not been in effect. This is quite significant considering that in 2009, the top marginal estate tax rate was 45% and the estate tax exclusion amount was $3.5 million (which enabled a decedent to protect only $3.5 million in assets from the estate tax).

Many billionaires have died in 2010, most notably George Steinbrenner, owner of the New York Yankees ($1.2 billion estate); Dan Duncan, Texas pipeline tycoon ($8 billion estate); John Kluge, philanthropist ($7 billion estate); and Glen Bell, founder of Taco Bell (value of estate unknown). Unless Congress seeks to reinstate the federal estate tax retroactive to January 1, 2010, the 2010 repeal will result in billions of dollars of estate tax savings for the heirs of these deceased billionaires.

The heirs of individuals who die after 2010 may not be so lucky. Unless Congress acts quickly and implements changes to the federal estate tax system, the federal estate tax is scheduled to return on January 1, 2011, with a top marginal rate of 55% and an estate tax exclusion amount of only $1 million. Based on these changes, the tax will affect a substantially higher number of estates.

For example, assume that John Smith dies in 2011 with a $300,000 home, $1 million dollar life insurance policy and $500,000 401(k) account (i.e.: a total estate of $1.8 million). Considering the changes that are scheduled to take effect, John Smith will be able to protect only $1 million of assets from the estate tax; therefore, $800,000 of his assets would be subject to the estate tax at a rate of 55%, resulting in an estate tax liability of more than $400,000.

What Does 2011 Hold?

Many believe that Congress will step in and implement (perhaps retroactive to January 1, 2010) a federal estate tax exclusion amount of around $3.5 million and a top marginal estate tax rate of around 45% (again, these are the figures that existed in 2009). However, the longer Congress waits, the more unlikely this becomes.

Additionally, 2010 is an election year, and Congress is gearing up to make other decisions that will not involve raising taxes. Further, if Congress simply decides not to address the estate tax issues, the exclusion amount will automatically fall to $1 million on January 1, 2011, with a top marginal estate tax rate of 55%. This may prove to be a backdoor way for Congress to generate revenue. What will happen is anyone's guess.

In any event, now is a good time for people to update their estate plans in order to implement strategies that are geared to reduce or eliminate potential estate tax liabilities, particularly if the federal estate tax exclusion amount indeed falls to $1 million, as scheduled. For instance, John Smith in the above example could establish an irrevocable life insurance trust (ILIT) during his lifetime and transfer his $1 million life insurance policy to it. Provided he survives for at least 3 years after making the transfer, the strategy would remove his $1 million life insurance policy from his estate for estate tax purposes. This strategy would reduce John Smith's estate to $800,000 (which is below the $1 million federal estate tax exclusion scheduled to take effect in 2011), and would result in estate tax savings of $400,000.

Gift Tax Exclusions

A gifting plan involving direct gifts to individuals and/or to various types of trusts is another strategy. In making gifts, the gifted assets are removed from the donor's estate and are not subject to estate taxes upon the donor's death. Individuals are entitled by law to an annual gift tax exclusion and a lifetime gift tax exclusion.

The annual gift tax exclusion gives a donor the ability to gift a specific amount each calendar year. The lifetime gift tax exclusion gives a donor the ability to gift an additional amount in total during lifetime (above and beyond the annual gift tax exclusions that are utilized by the donor). In 2011, the annual gift tax exclusion is scheduled to be $13,000 (as may be adjusted by inflation), and the lifetime gift tax exclusion is scheduled to be $1 million. It is worthwhile to note that real estate, securities and other assets have substantially decreased in value during the past few years, and the interest rate that the Internal Revenue Service requires donors to use in calculating the value of certain gifts to trusts is extremely low at this time. These factors give donors the opportunity to make best use of their annual gift tax exclusions and lifetime gift tax exclusion.

Review Your Estate Plans

The federal deficit is at an all-time high, and most believe that taxes and increased tax rates will be implemented in an attempt to reduce the deficit. This is a critical time for people to review their estate plans in order to ensure that, among other things, they are set up in a way that will provide them with the maximum estate tax savings. Considering the state of the market and economy, it is also an opportune time to take advantage of estate planning strategies like the ones described above.