

Estate and Gift Tax Laws: New Rules

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

On December 17, 2010, President Obama signed into law bipartisan legislation to extend all Bush-era tax cuts for two years. The new legislation, titled the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,” includes the following sweeping changes to the federal estate and gift tax rules:

Estate Tax Relief

- The federal estate tax exemption has been increased to \$5 million per person (\$10 million for a married couple). The exemption amount will be indexed for inflation beginning in 2012.
- The top tax rate for the estate, gift, and generation skipping tax has been lowered to 35%.
- **Election for deaths in 2010.** The default rule is that the federal estate tax is reinstated as of January 1, 2010 with a \$5 million exemption and a 35% tax rate, however, the estate of someone dying in 2010 may choose between the new rules and prior law. Estates electing out of the default rules will be subject to no federal estate tax, but appreciated assets included in the estate will only receive a “modified carryover basis” adjustment of up to \$1.3 million (more for spousal transfers). Electing out of the \$5 million estate tax exemption may favor very large estates, but the decision requires a careful weighing of the results under both scenarios. The election to opt out of the estate tax must be made by the estate administrator no later than September 17, 2011 (nine months from the date on which President Obama signed the new law).

Other changes

- **Reunification.** The new legislation “reunifies” the estate and gift tax rules and permits the use of the entire \$5 million exemption to make lifetime gifts. (The 2001 Tax Act had “de-coupled” the estate and gift tax systems, limiting the gift tax exemption to \$1 million, while incrementally increasing the estate tax exemption to as high as \$3.5 million for 2009.) This important change to the federal estate and gift tax rules creates tremendous opportunities to leverage the \$5 million exemption amount through lifetime gifting.
- **Portability.** The new legislation allows the executor of a deceased spouse’s estate to transfer any unused portion of the deceased spouse’s estate tax exemption to a surviving spouse. (Under the old rules, careful trust planning was required to ensure that married couples did not “under-use” their respective estate tax exemptions at the death of either spouse.)

Example. Assume Husband dies in 2011 having made lifetime gifts to children that used up \$2 million of his exemption. At death, he leaves his remaining \$3 million estate directly to his surviving



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spouse. The executor of Husband's estate elects to permit the surviving spouse to use Husband's unused \$3 million exemption, giving the surviving spouse an \$8 million exemption (her original \$5 million exemption, plus the deceased spouse's \$3 million unused exemption).

Although the new "portability" of the estate tax exemption prevents married couples from wasting their respective estate tax exemptions, trust planning for married couples may still provide meaningful benefits, such as eliminating estate taxes on post-mortem appreciation, and protecting the inheritance of heirs.

What is NOT included in the proposal

- **No GRAT limitations.** The new law does not contain restrictions or limitations on the use of Grantor Retained Annuity Trusts (GRATs), which had been debated in Congress earlier in 2010. As a result, short-term GRATs may still be leveraged to transfer wealth in a tax-efficient manner.
- **No valuation discount limitations.** The new law does not contain restrictions or limitations on the applicability of valuation discounts to intra-family transfers of business interests.

Summary

As a result of the new changes to the federal estate and gift tax rules, the vast majority of Americans will not be subject to the federal estate tax. In 2009, the number of estates larger than \$5 million that paid federal estate taxes was fewer than 4,300, or less than 2/10ths of 1 percent of all estates.

Nevertheless, the benefits of creating a comprehensive and thoughtful estate plan will continue to be just as important and beneficial to individuals and families for numerous reasons, including the following:

- There are numerous qualitative, non-tax benefits to having a comprehensive set of estate planning documents prepared by a qualified attorney. These documents should generally include: a revocable living trust, a pour-over will, a power of attorney for financial matters, and advanced health care directives. It may be advisable to review your existing estate planning documents in light of the new changes to the federal estate and gift tax laws.
- Finally, it is important to note that these new rules are only effective through December 31, 2012. Unless Congress acts again, the gift, estate, and GST exemptions will revert to \$1 million and the top tax rate will revert to 55%. Extension of these rules will likely be debated during the next election cycle.

To learn more about the new federal estate and gift tax rules and how they might affect you and your family, consult with your Baird financial advisor.

This information is not provided as legal advice, but for information purposes only. You are strongly advised to seek advice from competent legal and tax counsel to determine the applicability of this information to your estate and financial planning decisions.