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2010 Tax Relief Act – Estate Plan

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HOW WILL THE TAX RELIEF ACT AFFECT YOUR ESTATE PLAN?

After much speculation as to what Congress would do regarding estate tax, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Act") has finally given us our answer.

Signed into law Dec. 17, the 2010 Act provides some good news for those concerned about estate tax. Rather than simply extending the 2009 rates and exemptions, the 2010 Act reduces rates and increases exemptions. It also provides some flexibility for the families of people who died in 2010.

But the outlook isn't completely rosy. The 2010 Act provides only temporary relief, so we again face the possibility of higher rates and lower exemptions in 2013.

Estate tax

The 2010 Act retroactively brings back the estate tax for all of 2010 with a $5 million exemption and a 35% tax rate. The 2010 Act extends these levels for 2011 and 2012, with an inflation adjustment on the exemption amount for 2012. Then in 2013, the exemption and top rate will return to $1,000,000 and 55%, unless Congress makes changes.
The 2010 Act may prove beneficial to many families with loved ones who died in 2010. Why? Because the estate tax repeal was accompanied by a limit on the step-up in basis, which could have caused many heirs to face significant income tax liability on the sale of the inherited assets.

Still, for some families the step-up in basis is less of an issue than the estate tax. So the 2010 Act provides an option to elect the pre-act estate tax rules for 2010.

Election for 2010

For anyone who died in 2010, the estate may either follow the new rules under the 2010 Act or elect to follow the pre-2010 Act rules.

First some background on step-up in basis:

- Generally, the income tax basis of most inherited property is "stepped up" to its date-of-death fair market value. This means that recipients of the property can sell it immediately without triggering capital gains tax. Even if they hold on to it, they typically will pay less capital gains tax whenever they do sell it than they would have if the basis hadn't been stepped up.
- In 2010 and before the enactment of the 2010 Act, the automatic step-up in basis was eliminated. Instead, estates could generally allocate up to $1.3 million to increase the basis of certain assets plus up to $3 million to increase the assets inherited by a surviving spouse.

So, if the estate of someone who died in 2010 doesn't exceed the new $5 million exemption (less any gift tax exemption used during life), then following the new rules will likely be more beneficial. No estate tax will be due anyway, and the deceased's heirs don't have to worry about any limits on the step-up in basis.

If the estate exceeds the decedent's available estate tax exemption, the decision becomes more complicated. Factors such as the extent of the possible estate tax liability, the extent to which assets have appreciated beyond the decedent's basis and the extent to which the assets are going to a surviving spouse versus other heirs will need to be considered.

Fortunately, the 2010 Act does give families some time to make this decision. It extends the estate tax filing deadline for estates of those dying from January 1, 2010 through December 17, 2010 to nine months after December 17, 2010.

GST tax

Initially, the generation-skipping transfer (GST) tax was also repealed for 2010. The 2010 Act brings it back for 2010 as well, with the same exemption amounts as the estate tax through 2012. However, the 2010 Act set the GST tax rate for 2010 at 0%.

For 2011 and 2012, the GST tax rate goes back to 35% to match the top estate tax rate in 2011 and 2012.

Gift tax

The gift tax was never repealed for 2010, so the 2010 Act provided no change to the gift tax rules for 2010. The exemption remained at $1 million and the top rate at 35%.

But, like the GST tax, the gift tax exemption and rate will follow the estate tax exemptions and top rates for 2011 and 2012 ($5,000,000 and 35%).

More flexibility for married couples

The 2010 Act includes a provision that will (temporarily) provide significant estate planning flexibility to married couples. If one spouse dies in 2011 or 2012 and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption.

Similar results can be achieved by making asset transfers between spouses during life and/or setting up certain trusts at death. But making this election will be much simpler and provide flexibility if proper planning hasn't been done before the first spouse's death.

Still, this election is currently available for only two years unless Congress extends it. Married couples shouldn't depend on the election being available to ensure that they take full advantage of both spouses' exemptions.

Also be aware that the provision doesn't allow the deceased spouse's remaining GST tax exemption to be used by the surviving spouse.

Charitable giving

Charitable giving can be an important part of many people's estate plans. The 2010 Act extends a couple of valuable charitable giving breaks through 2011:

1. ***Tax-free IRA distributions for charitable purposes.*** You can make a direct contribution from your IRA to a qualified charitable organization without owing any income tax on the distribution. If you're subject to required minimum distributions, the contribution can be used to satisfy that requirement. The maximum allowable distribution for charitable contribution purposes is $100,000 per tax year.
2. ***Contributions of capital gains real property for conservation purposes.*** You can make a contribution of conservation real property and take a larger deduction than is allowed for most other capital gains property contributions. Specifically, your deduction for a contribution of capital gains real property for conservation purposes

generally can be up to 50% of your adjusted gross income (AGI) rather than the 30% of AGI limit that normally applies to contributions of capital gains property.

Other estate changes

There were several sun-setting provisions related to estate taxes that the 2010 Act was not addressed. One provision that may be beneficial is the return of the estate tax credit for state estate taxes paid.

Time to review your estate plan

With the many changes going into effect and the uncertainty about what will happen with the estate, GST and gift taxes in 2013, it's critical to revisit your estate plan. If you don't, the changes could result in your assets not being distributed according to your wishes or your family paying unnecessary taxes.

The law is complex and there are many contingencies to consider. We'd be pleased to work with you and your attorney to review your estate plan and update it as needed in light of the 2010 Act.

Transfer tax exemptions and rates for 2009–2013

	2009	**2010**	**2011**	**2012**	**2013**
Gift tax exemption	$1 million	$1 million	$5 million	$5 million[2]	$1 million
Estate tax exemption[1]	$3.5 million	$5 million[3]	$5 million	$5 million[2]	$1 million
Generation-skipping transfer (GST) tax exemption	$3.5 million	$5 million	$5 million	$5 million[2]	$1 million[2]
Highest gift and estate tax rates and GST tax rate	45%	35%[3] 0% for GST tax	35%	35%	55%[4]

[1] Less any gift tax exemption already used during life. For 2011 and 2012, these amounts are "portable" between spouses.
[2] Indexed for inflation.
[3] Estates can elect to follow the pre-2010 Act rules (estate tax repeal + limited step-up in basis).
[4] The benefits of the graduated gift and estate tax rates and exemptions are phased out for gifts/estates over $10 million.

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For questions, please contact a Kerkering Barberio professional tax advisor at 941-365-4617.