

Easing the Burden of Estate Tax

The new tax law relieves many taxpayers from concerns about federal estate tax for the next two years. What's more, the law clarifies the treatment of estates of the people who died last year.

New Rules

For 2011 and 2012, the federal estate tax exemption is set for \$5 million. That's a significant increase over the \$3.5 million exemption for deaths in 2009 and a huge jump from the \$1 million exemption that would have taken effect if a new law had not been passed. Excess assets are now taxed at 35%, down from 45% in 2009. As before, bequests to charities and surviving spouses who are American citizens are not subject to estate tax, regardless of the amount.

Perhaps most important, the new law includes "portability" of the estate tax exemption between spouses. Any exemption amount not used by the first spouse to die can be used by the estate of the surviving spouse, in addition to his or her own allowed exemption.

Example: George Wilson has a \$5 million net worth and his wife, May, has \$3 million of assets. In a traditional plan, George's will calls for his assets to be left in trust for May and their children up to the amount of the federal estate tax exemption, with the balance of George's estate going to May. This arrangement enables George's estate to maximize his estate tax exemption. However, this plan also moves \$5 million out of May's easy reach.

In an alternate plan, George might leave all of his assets to May, which would be a tax-free bequest. George could then name either a trust or their children as secondary beneficiaries. At George's death, May could disclaim (relinquish) some or all of the inheritance to the backup beneficiary, depending on how much she needs.

This type of disclaimer strategy, though, relies upon the ability of the surviving spouse to make an astute decision. If the survivor fails to do so, the plan might go awry. In this example, if May neglects to disclaim any assets and subsequently dies with an \$8 million estate, assuming a \$5 million estate tax exemption and a 35% estate tax, the estate could owe more than \$1 million in tax on the excess \$3 million.

Under the new rules, married couples can avoid such dilemmas. George, with a \$5 million estate, can leave as much as he wants to May and as much as he wants to his children. Any unused tax exemption will go to May.

Say that George leaves \$2 million to his children and \$3 million to May, and May subsequently dies with \$6 million in a year that the federal estate tax exemption is \$5 million. Because George used only \$2 million of his exemption with the bequest to their children, the \$3 million that wasn't used passes to May's estate. This brings the total exemption for May up to \$8 million at her death. Even though May dies with \$6 million, her estate has an \$8 million exemption to offset any estate tax due. In essence, the new law provides married couples with a total estate tax exemption of \$10 million and reduces the need for complicated estate tax strategies.

Clarity for 2010 estates

Throughout 2010, the federal estate tax was not in effect. Many people expected this tax to be reinstated retroactively. Thus, there was a great deal of uncertainty for the estates of people who died last year. The new tax law sets the rules for federal estate tax in 2011 and 2012. In addition, it gives 2010 estates the choice of using the 2011 law or the law as it applied during 2010, as follows:

- **The 2011 law.** Decedents have a \$5 million federal estate tax exemption. Excess assets are taxed at 35%. Inherited assets have the date-of-death value as their basis, although executors can choose to use the value of estate assets exactly six months after death. As a result, heirs generally do not owe capital gains on the appreciation of the assets during the decedent's lifetime.

- **The 2010 law.** As mentioned, estates owe no federal estate tax for deaths last year. There may be a capital gains tax, though, when heirs sell appreciated assets. Assets passed at death retain the decedent's basis, plus a step-up in basis of no more than \$1.3 million, or \$4.3 million for assets placed to a surviving spouse, allocated by the executor of the estate among the decedent's properties.

The bottom line is that estates under \$5 million need not worry about federal estate tax. They can use the 2011 rules and avoid paying estate tax while minimizing future capital gains tax.

Executors of estates over \$5 million face a more difficult choice. They can use the 2011 rules and pay 35% tax on amounts over \$5 million (\$350,000 on a \$6 million estate, for example). Alternatively, they can choose the 2010 rules and avoid federal estate tax. If they choose the 2010 rules, executors will have to track the decedent's basis in all the assets passed on to beneficiaries who might owe tax on future sales. Our office can help executors of 2010 estates make the choice that is better for heirs.

Triple play

Just as the new law sets the federal estate tax exemption for 2011 and 2012 at \$5 million, it also raises the federal gift tax exemption to \$5 million during those two years, up from \$1 million in 2010. Excess lifetime gifts will be taxed at 35%.

The expanded gift tax exemption and 35% gift tax rate provide an excellent opportunity for wealthy taxpayers. At least for the next two years, people who are concerned about future estate tax can move large amounts to younger generations while owing little or no gift tax.

The same \$5 million exemption and 35% rate also are set for the generation-skipping transfer tax in 2011 and 2012. Therefore, wealthy taxpayers will find planning easier now that all three taxes have the same exemption amount and tax rate, at least for this past year and next.

Altogether, few taxpayers will have to face federal estate, gift, or generation-skipping transfer tax because of the expanded exemption amounts. However, state taxes might be a concern, so you should consider them in your estate planning.