

Estate Tax Changes in the 2010 Tax Relief Act

The estates of individuals who died in 2010 didn't pay any federal estate tax, but that situation is about to change. Under the recently enacted "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," the federal estate tax, which disappeared for 2010, springs back to life in 2011 and is imposed at the top rate of 35% of the estate's value after the first \$5 million.

Background

The modern estate tax dates back to 1916, when it was imposed at a rate of 10% on the portion of estates above \$50,000. Over the following years, the rates and exemption amounts have varied, reaching a high of 77% from 1941 to 1976 with a \$60,000 exemption amount.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the first of the two large legislative packages that contain most of what are now commonly referred to as the "Bush tax cuts." EGTRRA gradually lowered the maximum estate tax rate and substantially raised the applicable exclusion amount over the years 2002 through 2009. The maximum tax rate fell from 60% under prior law in 2001 (a 55% marginal rate on taxable estate values over \$3 million plus a 5% surtax from \$10 million to \$17 million) to 45% in 2007-2009. EGTRRA repealed the estate tax completely for decedents dying in 2010. That led to several well-publicized instances in which famous people died in 2010 leaving multibillion-dollar estates that will pass to their heirs without paying so much as a penny in federal estate tax. However, all of those provisions were scheduled to sunset on December 31, 2010, meaning that if Congress had not acted, starting January 1, 2011, the estate tax would have sprung back at a level that no one seemed to want. Where the exclusion was \$3.5 million (\$7 million for couples) in 2009 – a level at which it affected relatively few households – it would have been \$1 million (\$2 million for couples) in 2011. The tax rate would also have risen, from a top rate of 45% in 2009, to a top rate of 55% in 2011.

New law

The new law brings back the estate tax, for 2011 and 2012 anyway. During 2011 and 2012, the top rate will be 35%. For 2011, the exemption amount will be \$5 million per individual (indexed for inflation after 2011). At those levels, the vast majority of estates (all but an estimated 3,500 nationwide in 2011) will not be subject to any federal estate tax, and the tax will raise about \$11.4 billion for the government. By way of comparison, the 55% tax with a \$1 million exemption would have resulted in about 43,540 taxable estates in 2011, and raised about \$34.4 billion. Tax historians would also note that except for the temporary repeal of the estate tax in 2010, the estate tax rate has not been less than 45% since 1931.

The new law also gives heirs of decedents dying in 2010 a choice of which estate-tax rules to apply – 2010's or 2011's. That's important because although there is no estate tax in 2010, some inherited assets are subject to higher capital gains tax under the 2010 rules, a situation that actually raises the tax burden for some heirs. Inherited assets under the 2010 rules have a tax basis equal to the price when they were purchased (referred to in tax parlance as "carryover basis") rather than the price at death. That could lead to a significant tax burden for heirs who sell assets such as stocks that had been held for many years and have greatly appreciated in value. Under the 2011 rules, by contrast, heirs will be allowed to inherit assets with a "stepped-up basis." While most heirs would choose the 2011 regime (\$5 million exemption from both estate and

generation-skipping tax and an unlimited step-up in the basis of assets to their current market value), the heirs of superrich decedents could find it more advantageous to elect the 2010 law (limited step-up in the basis of assets and no estate tax). If the executor makes the election to have the 2010 rules apply, the estate tax return's due date will not be earlier than the date that's nine months after the new law's enactment date.

For gifts made after December 31, 2010, the gift tax will be reunified with the estate tax. Under the new law, the estate and gift tax exemptions will be reunified starting in 2011, which means that the \$5 million estate tax exemption will also be available for gifts. The law in effect prior to 2010 provided a \$3.5 million lifetime exemption for estates, but only \$1 million for gifts. The gift tax rate, starting in 2011, will be 35%. The exemption from the generation-skipping tax (GST) – the additional tax on gifts and bequests to grandchildren when their parents are still alive – will also rise to \$5 million from the \$1 million it would have been without the new law. The GST tax rate for transfers made in 2011 and 2012 will be 35%.

From a planning standpoint, a nice feature of the new law is that it makes it easier to transfer the \$5 million exemption to a surviving spouse, so married couples can shield \$10 million of their assets from taxes. In the language of tax professionals, the estate tax exemption will be “portable.”

I hope this information is helpful. If you would like more details about the estate tax or any other aspect of the new law, please do not hesitate to call.