

NEW ESTATE & GIFT TAX LAWS ARE NOW IN EFFECT: *THE 2010 TAX RELIEF ACT*

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INTRODUCTION

On December 17, 2010, President Obama signed the 2010 Tax Relief Act (the "TRA") which amended the federal estate, gift, and generation skipping transfer tax laws for two years. While this article highlights relevant portions of the TRA, this new law is extremely complex and we recommend you consult us if you have any questions on the application of the TRA to your own estate plan.

The changed laws may impact your estate planning, particularly if:

- The value of your estate is greater than \$1 million,
- Your assets have appreciated substantially since you acquired them,
- Your estate plan includes a bypass or credit shelter or A/B trust, especially if the trust was created primarily for tax-saving purposes, or
- Gifting is an important part of your tax plan.

PROVISIONS OF THE TRA

1. Increased estate tax exemptions for 2011 and 2012. In 2010 there was no federal estate tax. Prior to the enactment of the TRA, the federal estate tax for 2011 was to be reinstated with an exemption amount of \$1,000,000 and a tax rate of 55% above the exemption amount.

The TRA provides that for tax years 2011 and 2012, the estate and gift tax exemption amount for each individual is \$5,000,000, and the federal estate tax rate for estates is 35% above the exemption amount.

For 2013 the estate tax and gift tax exemption reverts to \$1,000,000 and the federal estate tax rate reverts to 55% above the exemption amount. Most commentators assume that Congress will change the \$1,000,000 exemption amount to \$3,500,000 or \$5,000,000 and change the federal estate tax rate to 35% or 45% before the end of 2012.

2. New gift tax rules. The TRA increased the lifetime gift tax exemption from \$1,000,000 to \$5,000,000, and taxes gifts above the exemption amount at 35%. The TRA continues the annual gift tax exemption for yearly gifts to individuals at \$13,000 a year.

3. Step up in basis for most assets passing at death. Before 2010 federal law provided that most assets passing at death received a new income tax cost basis equal to the value of the asset at the date of death. This rule is commonly called a "step up in basis," meaning most inherited assets receive a new income tax cost basis. This rule does not apply to IRAs and 401ks. The law in effect in 2010 eliminated the step up in basis rules and replaced them with complex modified carryover basis provisions.

The TRA reinstates the more favorable step up in basis rules for individuals dying in 2011 and 2012. The complex modified carryover basis provisions will now only apply to 2010 estates if elected. After the expiration of the TRA on December 31, 2012, the more favorable step up in basis rules will continue to apply with some changes.

4. New generation skipping transfer tax rules. In the past, federal law imposed a generation skipping transfer tax on the transfer of assets to “skip persons” – a transfer to a beneficiary in a generation more than one generation younger than the person transferring assets during life or at death. The complex definition of a skip person includes beneficiaries who are related or unrelated to the person transferring assets. This tax, commonly known as a “GST tax,” is in addition to the federal estate tax.

The TRA reinstates the GST tax for transfers to skip persons, the GST exemption amount is \$5,000,000, and the GST tax rate is 35% of any transfer above the GST exemption amount.

5. Treatment of 2010 deaths under the TRA and election to apply 2010 law. For the most part, the TRA rules apply the estates of individuals dying in 2010. That is, the estate tax will be based on the new \$5,000,000 exemption amount and 35% estate tax rate with the new favorable step up in basis rules – unless the executor elects out of these rules. If the executor so elects, then the 2010 rules of no estate tax and complex modified carryover basis rules will apply. In most cases, executors need only analyze this election for estates with a value of \$5,000,000 or more.

6. New portability rules. The TRA enacts an entirely new rule allowing a surviving spouse to claim any unused federal estate tax exemption from the estate of the first spouse to die. This new rule is commonly known as "portability," meaning the estate of a surviving spouse can claim the unused portion of the \$5,000,000 federal estate tax exemption of the estate of the deceased spouse. The TRA requires complicated steps to be taken before the estate of a surviving spouse can claim the unused federal estate tax exemption amount of the deceased spouse.

7. New federal estate tax filing rules. The TRA gives estates of decedents dying in 2010 extended time to file appropriate federal estate tax and informational returns.

CONCLUSION

This article is a brief summary of important estate, gift, and generation skipping tax provisions of the TRA. Trustees and executors settling decedents' estates should have competent professional advice on the impact and application of the TRA to those estates. The new portability rules mean that even estates which do not create Credit Shelter, Bypass or A/B Trusts on the death of the first spouse need to decide whether to file an informational federal estate tax return. Also, estates of decedents who died in 2010 should make a determination as to whether to apply the TRA or the optional 2010 law. Finally, the TRA only increases the federal estate tax exemption to \$5,000,000 for 2011 and 2012. Although many experts believe that the permanent federal estate tax exemption amount will be \$3,500,000 or \$5,000,000, review of existing estate plans which create Credit Shelter Trusts, Bypass Trusts, or A/B Trusts is highly recommended since an Optional Tax Savings Trust (“Disclaimer” Trust) may provide more flexibility.

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