

ESTATE PLANNING TAXATION

ESTATE TAX RELIEF ARRIVES FOR THE HOLIDAYS: THE EXCLUSION IS UP AND THE RATE IS DOWN Congress Acts to Avert Higher Estate Taxes in 2011 - but the Changes are Effective only through 2012

by Henry M. Grix
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Just after midnight on December 17, Congress made sweeping changes to our gift, estate, and generation-skipping transfer tax system—at least during the period from 2010 through 2012. Gift, estate, and generation-skipping transfer taxes are imposed on transfers of wealth made during life and at death. If they apply, these transfer taxes are to be avoided to the extent possible because they historically have been assessed at relatively high rates. The new law brings welcome relief for individuals and families. It increases to \$5 million the amount that an individual can shelter from gift, estate, and generation-skipping transfer taxes, and it facilitates the transfer of \$10 million by a married couple without estate tax. For transfers over these sheltered amounts, the transfer tax rate is reduced to 35% (from the 2009 rate of 45% and a top marginal rate of 55% that had been scheduled to take effect in 2011).

Unfortunately, the legislation has a relatively short shelf life. The new transfer tax legislation was part of the tax package negotiated by President Obama and Congressional Republicans to extend the so-called “Bush tax cuts.” While the income tax rate provisions simply extend current law for two more years, the new gift, estate and generation-skipping transfer tax provisions materially change prior law.

If Congress had not acted before the end of 2010, a 10-year period of estate, gift and generation-skipping transfer tax relief would have ended in 2011 when the rules applicable in 2001 were scheduled to return. This “snap back” to 2001 would have provided each individual with only a \$1 million exemption from estate and gift taxes and would have set a top marginal estate and gift tax rate of 55% on transfers of \$3 million or more.

The new law includes the following taxpayer-friendly features:

2010 Option for Total Estate Tax Repeal

During 2010 only, taxpayers have the option to take advantage of a total repeal of estate and generation-skipping transfer taxes. For example, the fiduciaries for the billionaire, George Steinbrenner, who died during 2010, may elect to have his estate entirely sheltered from any estate tax. The price of selecting this option is called “modified carryover basis.” Modified carryover basis means that the persons who receive Mr. Steinbrenner’s assets also will inherit Mr. Steinbrenner’s income tax basis in those assets, with some modifications. Thus, if Mr. Steinbrenner had paid \$100 for a security that was transferred at this

death, the recipient must recognize capital gain if and when she sells it (subject to certain exceptions).

2010 Option for the \$5 million Estate Tax Exclusion and a 35% Rate

The new law affords an alternative during 2010. Estate tax applies, but with the new \$5 million exclusion and a rate of 35% on transfers in excess of the exclusion. Under this 2010 default rule, the decedent’s income tax basis in all assets transferred at death is adjusted to the values of those assets on the decedent’s date of death, and the recipients of the assets thus may avoid income tax recognition of any built-in gain between the date a decedent acquired an asset and the date of death. For example, if an individual dies during 2010 owning assets valued at \$5 million, no estate tax will be payable because of the exclusion amount, and the beneficiaries will receive an adjustment in basis in each asset to the value at the date of death.

In 2011 and 2012, the new \$5 million exclusion amount and 35% rate apply. The exclusion also is indexed for inflation so that, in 2012, it may increase.

Consider this example of how the new law will work. Mrs. Jones, a widow, dies during 2012 with an estate of \$5.1 million. Assuming no indexing of the exclusion amount occurs, the \$5 million exclusion leaves only \$100,000 of her assets exposed to estate tax at the 35% rate so that her estate tax would be \$35,000. This estate tax could be reduced by deductions such as administrative expenses and any gifts to charity. Furthermore, if by 2012, there has been a sufficient increase in the cost of living, the indexed exclusion may cover Mrs. Jones’s entire estate, regardless of any deductions. In any case, Mrs. Jones’s beneficiaries will receive assets with adjustment in basis to their values on the date of Mrs. Jones’s death.

Portability for Married Couples

Beginning in 2011 and through 2012, a new concept, called “portability” eases the ability of a married couple to assure that, between them, \$10 million will be sheltered from estate tax. Under our prior transfer tax system, a married couple generally has been counseled to split their assets between them so that, regardless of who dies first, each spouse would own sufficient assets to take advantage of the applicable estate tax exemption at death. The target was for each spouse to own assets at least equal to the estate tax exemption amount, but this target could be unattainable in cases where a spouse owned an asset that could not easily be transferred, such as closely-held stock or a large retirement accumulation. With portability, the second spouse to die may utilize, at his or her later death, any unused exclusion amount of the first spouse to die, and it becomes less important in many cases for spouses to divide their assets during their joint lifetimes.

During 2011 and 2012, estate and gift taxes are unified.

During 2011 and 2012, the \$5 million exclusion amount is available for lifetime gifts. Prior to the new legislation, the maximum lifetime taxable gift was fixed at \$1 million even in 2009 when the estate tax exemption was \$3.5 million. Consider this example. Mr. Smith, who had never made a lifetime taxable gift, decides to give \$2.5 million to each one of his two children in 2011, for a total taxable gift of \$5 million. Mr. Smith owes no gift tax because his transfers are sheltered by the \$5 million exclusion. At Mr. Smith's later death, the lifetime gifts of \$5 million return to his transfer tax base (along with the unified estate and gift tax exclusion), but any post-gift appreciation escapes the transfer tax system.

During 2010 only, the generation-skipping transfer tax rate is zero.

Transfers to grandchildren or younger descendants are subject not only to estate or gift tax but also to a special "generation-skipping" transfer tax that has been assessed at a flat rate equal to the highest estate tax rate. During the waning days of 2010, the new legislation presents a significant generation-skipping transfer tax planning opportunity. Before the end of year, certain generation-skipping transfers, including both outright gifts and certain trust gifts to grandchildren or younger beneficiaries, may be structured to escape generation-skipping transfer tax altogether. This is because the effective generation-skipping transfer tax rate during the balance of 2010 is zero.

In 2011 and 2012, generation-skipping transfers will be exposed to a 35% rate, subject to a \$5 million exclusion amount.

What should individuals and families make of the new law?

- The increased \$5 million exclusion (\$10 million for a married couple) will remove the vast majority of individuals and families from the estate, gift and generation-skipping transfer tax system at least during the period from 2010 through 2012.
- Given the uncertainty of the transfer tax system after 2012, it will be important to review carefully whether tax-driven planning should be put in place now and whether planning undertaken in prior years should be retained or, if feasible, be un-done.
- Individuals who are considering transfers to grandchildren or younger generation descendants should consult their advisers immediately to determine if they can take advantage the zero generation-skipping tax rate that will expire after December 31, 2010.
- The new law includes important reporting requirements. Fiduciaries of individuals dying during the period from 2010 through 2012 should seek professional assistance to reap benefits of the new law. Similarly, individuals who make taxable gifts need to report those gifts accurately.

- The new \$5 million lifetime exclusion and today's low interest rate environment combine to make certain lifetime gifts particularly attractive, particularly gifts of assets that may be expected to appreciate over the longer term.

Please contact Dickinson Wright's trusts and estates lawyers to learn more about how you and your family best can take advantage of the favorable changes delivered by Congress in time for the holidays.



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