Middle Class Tax Relief Act of 2010: Estate and Gift Tax Changes

The Middle Class Tax Relief Act of 2010 (the "Act"), which has just gone into effect, will have a significant impact on estate tax planning. It applies to the estates of those who died in 2010 and who will die in 2011 and 2012. Further legislation is expected to cover tax treatment of gifts and deaths that occur in 2013 and beyond. In the meantime, you need to review your existing estate plans in light of the Act.

Under the prior law, there was no federal estate tax for those U.S. residents and citizens dying in 2010 (you probably read about the Steinbrenner estate). Nonetheless, estate practitioners and beneficiaries of 2010 estates were fearful of a retroactive estate tax.

The Act does, in fact, provide that estates of decedents who died in 2010 are retroactively subject to a federal estate tax with a $5 million estate tax exemption (an increase over the $3.5 million exemption in 2009). Most assets in those estates will receive a "step-up" in the tax basis to the value on the date of the decedent's death. However, the Act provides relief by allowing the personal representative of a 2010 estate to elect out of the estate tax. The benefit of electing out is coupled with the burden of retaining the decedent's adjusted cost basis ("carryover basis") for each estate asset. Although the Act permits a limited step-up in basis, a sale of inherited appreciated assets by the beneficiary of an estate that opts out of the estate tax could trigger a significant capital gain. The impact of the capital gains tax on the sale of inherited assets plus the impact of any applicable state estate taxes makes the election for no federal estate tax more complex than initially appears to be the case and requires careful professional analysis.

For the estates of those who die in 2011 and 2012, there is no choice—there is an estate tax law that will apply. A $5 million exemption is available to all estates (indexed for inflation for 2012) with a 35% rate for taxable assets in excess of $5 million. The tax bases of most assets are stepped-up to the value on the date of death.

Federal Exemption for Married Couples

For married couples, the available federal exemption may be even richer. A new concept has been introduced into estate planning with the passage of the Act—"portability" of the unused exemption from one spouse's estate to the other's. What does this mean and how does it work? In its simplest form, suppose George dies in 2011 and leaves all his assets to his U.S. citizen spouse, Martha. His estate does not need to utilize any of his $5 million exemption because of the marital deduction. When Martha dies (assuming she hasn't remarried and been widowed again), her executor can add George's unused $5 million exemption to Martha's $5 million, thereby allowing Martha to pass $10 million of assets to their children without paying any estate or gift tax.

Although it may seem that portability makes estate planning unnecessary, it may be prudent to create an exemption trust in the first spouse's estate in order to protect any future appreciation of estate assets from taxation in the second spouse's estate, protect the assets from the reach of the second spouse's creditors and keep some assets available for the next generation. However, you should carefully consider the amount of state estate taxes that may result if you use exemption trust planning.

Alert Concerning Exemption or Bypass Trusts for NY Residents

In an estate that uses the federal exemption amount to fund an exemption or bypass trust upon the death of the first spouse, if the exemption is pegged to the unused full federal exemption amount ($5 million), a tax of $391,600 will be due to New York State nine months from death. Although that may make sense for some clients, other clients may not want to pay now for a tax saving that may occur many years in the future. More important, the old formula language may now load so much of the assets in the estate of the first to die into the exemption or bypass trust as to fundamentally distort the testator's original intentions. Again, it is important to review the tax and practical consequences of any existing estate plan or will.

Gift and Generation-Skipping Transfer Tax Exemptions

The Act also increases the lifetime exemption for gifts to $5 million for 2011 and 2012, resulting in a unified estate and gift tax system. This change creates new opportunities for clients who already have gifted the maximum amount permitted to be exempt from taxes under the old law ($1 million) to utilize tax minimization strategies such as qualified personal residence trusts ("QPRTs"). Owners of high-end residences for whom a $1 million exemption was inadequate to cover the value of the gifted interest in a QPRT may want to rethink the QPRT concept.

In addition, the generation-skipping transfer tax ("GSTT") exemption has been increased to $5 million for 2011 and 2012. The increased gift and GSTT exemptions create opportunities for large gifts to trusts for grandchildren. Historically high gift and generation-skipping tax exemptions make the next two years a good time to shelter future appreciation of family businesses or homes that will increase in value over the next decades.

Should you have any questions, please feel free to contact us at info@tarterkrinsky.com.