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New Estate and Gift Tax Rules Offer Many Planning Opportunities

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Recently we wrote about many of the provisions contained in the ***Tax Relief Job Creation Act of 2010 — "The 2010 Act"***. In that article we focused primarily on the new income tax rules that will affect most people in 2011 and in 2012. However, many tax professionals feel that the estate and gift tax provisions contained in this landmark tax legislation were the greatest Christmas gift of 2010 to the American people. The 2010 Act contains many new estate and gift tax planning opportunities that merit further review. Let's take a look at these opportunities.

While estate tax has been a hot issue recently, it has been around since the 1920's. Prior to 2001, the top rate was 55%, and the exemption was a paltry $675,000 per person. This low exemption amount began to snare more and more middle-class Americans, including heirs of California homeowners who found themselves unexpectedly paying estate taxes. Making gifts prior to death was another planning tool for transferring wealth. However, gifts reduced the $675,000 lifetime exemption making this strategy of limited value.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) passed in 2001 changed the estate and gift tax rules. The estate tax lifetime exemption increased to $1 million per person in 2001 and was scheduled to rise to $3.5 million by 2009. In addition, the top estate tax rate was reduced from 55% down to 45% during this same period. However, this bill called for the estate tax to disappear entirely in 2010 and then reappear in 2011 back at a $1 million lifetime exemption. The reason Congress passed these peculiar provisions was to force future legislators to pass a new estate and gift tax law prior to 2010.

As we now know, Congressional failure to pass a tax bill in 2009 caused temporary suspension of the estate tax in 2010. In addition, gift tax was set at a 35% tax rate with no lifetime exemption. Many large estates (such as Texas oilman Dan Duncan's estimated $9 billion net worth and NY Yankees owner George Steinbrenner's $1 billion plus estate) were passed to their heirs with no estate tax liability. In late 2010, just prior to the estate tax laws reverting back to a $1 million lifetime exemption, the 2010 Act altered the estate and gift tax landscape.

The most noteworthy estate tax provisions of the 2010 Act are the $5 million per person estate tax exemption coupled with the estate tax rate being reduced to 35%. The new rules also allow a surviving spouse's estate to use any unused portion of the $5 million exemption from their pre-deceased spouse's estate to exempt assets in the second estate. These provisions virtually guarantee every married couple a full exemption up to $10 million of estate assets. Clearly, these liberalized limits will allow many more families to pay no estate taxes or significantly reduce their estate tax liability.

The 2010 Act continues the rules allowing a full step-up in basis of capital assets (such as real estate, stocks, bonds, mutual funds, etc.) held as community property and a partial step-up for joint tenancy property. Of particular note, special provisions for 2010 estates allow these estates to choose between two dramatically different approaches for estate tax and basis step-up. Estates of 2010 decedents can opt to pay no estate tax as the law provided, however, be saddled with significantly reduced allowances for basis step-up. An alternative approach is to voluntarily elect to pay the estate tax using the new 2011 rates and exemptions in order to be eligible for a full step-up in basis for all capital assets in the estate. In cases where an estate is over $5 million it could be beneficial to file the estate tax return even if some estate taxes need to be paid. The estates most likely to benefit from filing a retroactive estate tax return are those holding many heavily appreciated assets, particularly if these assets were sold soon after death. If the capital gains taxes exceed the estate tax liability, then it makes perfect sense to retroactively file an estate tax return to claim the step-up in basis. These 2010 estate situations will call for careful planning with an attorney or CPA.

Just as EGTRRA was intended to force follow up legislation, the 2010 Act will revert to a $1 million lifetime exemption and a 55% tax rate in 2013 if no bill follows. This future uncertainty makes 2011 and 2012 critical planning years. Unfortunately, these decisions may need to be executed without benefit of knowing where the estate and gift tax is heading in 2013.

Perhaps the greatest planning opportunities of the 2010 Act can be found in the gift and generation skipping transfer (GST) areas. Through the end of 2012 the gift tax and the GST exemptions will also be set at $5 million for individuals and $10 million for couples. These exemptions are five times higher than the previous exemption amounts. The tax rate on gifts above $5 million is now set at 35% instead of the previous rate of 45%. These rules offer wealthy estates some unique opportunities to significantly reduce future estate tax liabilities.

One strategy calls for individuals approaching the $5 million and $10 million exemptions to make gifts now rather than retaining all the estate assets to pass at their death. If gift tax or GST exemptions are reduced after 2012, property gifted during this period will have escaped transfer taxes. Keep in mind, however, that the basis of gifted assets will not be stepped-up for these transfers. Another reason to gift assets now is that all future appreciation in value realized on gifted property will be removed from the estate at death. Even estates holding less than $4 million in assets may want to consider making gifts, especially if the exemption amount for gifts is lowered after 2012. This strategy can be even more effective with estate assets that are rapidly appreciating.

Beyond the financial and political considerations of making large gifts over the next two years, there are certain social and emotional issues to consider before making large gifts. In particular, there is the question of how much control one is willing to relinquish over one's assets. As one Virginia attorney warns, "You will not get the money back, your heirs probably won't write you a thank-you note, and you won't necessarily approve of how they spend the money." Some who are otherwise capable of making large gifts to their children choose not to do so for fear that their children might lose their incentives to achieve their own success.

If you are considering gifting to take advantage of this window of opportunity, we have a few caveats to consider. First, it is unclear what will happen to gifts made in 2011 and 2012 should the exemption amount be reduced in the future. Congress may choose to grandfather these gifts with still no tax due or they may choose to tax gifts greater than the future exemption amount at the time of the donor's death. In past situations like this one Congress has opted for grandfathering rather than tax prior year actions.

Second, it is important to remember that the recipient of a gift also inherits the giver's original cost basis for the asset. Even though the gift avoids the estate and/or gift tax upon transfer, the recipient will owe income tax on potentially higher capital gains without the basis step-up.

Third, large gifts frequently involve the establishment of a trust, and often require the services of an institution to act as trustee. Institutional trustees come with a cost and they frequently are cold and dispassionate in their administrative decision-making.

A final thing to keep in mind is that strategizing large-scale gifting can become very complex, and it is wise to work closely with an attorney or other advisor to ensure that your goals are met and that you receive all the benefits available to you. While the new rules are ripe with opportunities, there are also many pitfalls to be avoided.

If you have any questions about whether or not gifting is right for you, or how we can help you find an attorney to effectuate your family's goals please call us at 408.260.3138, or e-mail us at arubin@werbarubin.com.