ROTROFF, FISHER & CO., P.A.

CERTIFIED PUBLIC ACCOUNTANTS

Dear Client:

RE: Estate and Gift Tax Changes in the 2010 Tax Relief Act

We are writing this letter to apprise you of the estate and gift tax changes in the recently enacted 2010 Tax Relief Act. Before the new law, there was no estate tax for 2010, but some beneficiaries could have faced higher taxes because there were less favorable income tax basis rules. Also, under the prior law, estate and other transfer taxes were scheduled to rise substantially for post-2010 transfers.

Overview of the new law. The 2010 Tax Relief Act provides temporary relief. Among other changes, it reduces estate, gift and generation-skipping transfer (GST) taxes for 2011 and 2012. It preserves estate tax repeal for 2010, but in a roundabout way: estates wanting zero estate tax for 2010 must elect that option, along with the less favorable modified carryover basis rules that were set to apply for 2010. Otherwise, by default, the estate tax is revived for 2010, with a $5 million exemption, a top tax rate of 35%, and a step-up in basis. Also, for estates of decedents dying after Dec. 31, 2010, a deceased spouse's unused exemption may be shifted to the surviving spouse. However, these generous rules are temporary—much harsher rules are slated to return after 2012.

Lower rate and higher exemption for 2011 and 2012. For estates of individuals dying in 2009, the top estate tax rate was 45% and there was a $3.5 million exemption. The top rate was to rise to 55% for estates of individuals dying after 2010, and the exemption was to be $1 million. For 2011 and 2012, the 2010 Tax Relief Act reduces the top rate to 35%. It also increases the exemption to $5 million for 2011 with a further increase for inflation in 2012. But these changes are temporary. After 2012, the top rate will be 55%, and the exemption will be $1 million.

Special tax saving choice for 2010. The 2010 Tax Relief Act allows estates of decedents who died in 2010 to choose between (1) estate tax (based on a $5 million exemption and 35% top rate) and a step-up in basis, or (2) no estate tax and modified carryover basis. Basis is the yardstick for measuring income tax gain or loss when an asset is sold. With a step-up in basis, pre-death gain is eliminated because the basis in the heir's hands is increased to the date of death value of the asset. On the other hand, with a modified carryover basis, an heir gets the decedent's original basis, plus certain increases, which can be substantial. Even so, if the decedent had a relatively low basis and significant assets, some pre-death gain may be taxed when the heir sells the property. These concerns factor into the special choice for 2010. The executor should make whichever choice would produce the lowest combined estate and income taxes for the estate and its beneficiaries. This would depend, among other factors, on the decedent's basis in the assets immediately before death and how soon the estate beneficiaries may sell the assets.

Gift tax changes. Years ago, the gift tax and the estate tax were unified—they shared a single exemption and were subject to the same rates. This was not the case in recent years. For example, in 2010, the top gift tax rate was 35% and the exemption was $1 million. For gifts made after Dec. 31, 2010, the gift tax and estate tax are reunified and an overall $5 million exemption applies.

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GST tax changes. The GST tax is an additional tax on gifts and bequests to grandchildren when their parents are still alive. The 2010 Tax Relief Act lowers GST taxes for 2011 and 2012 by increasing the exemption amount from $1 million to $5 million (as indexed after 2011) and reducing the rate from 55% to 35%.

New portability feature. Under the 2010 Tax Relief Act, any exemption that remains unused as of the death of a spouse who dies after Dec. 31, 2010 and before Jan. 1, 2013 is generally available for use by the surviving spouse in addition to his or her own $5 million exemption for taxable transfers made during life or at death. Under prior law, the exemption of the first spouse to die would be lost if not used. This could happen where the spouse with resources below the exemption amount died before the richer spouse. One way to address that was to set up a trust for the poorer spouse. Now, the portability rule may make setting up a trust unnecessary in some cases. But there still may be other reasons to employ credit shelter trusts. For example, a credit shelter trust may protect appreciation occurring between the death of the first spouse and the death of the second spouse from being subject to estate tax. Such a trust also can protect against creditors. Plus, the transferred exemption may be lost if the surviving spouse remarries and is again widowed.

Conclusion. The estate tax relief in the new law is substantial, but it is temporary. Estate planning to reduce taxes remains an important consideration. Even if taxes are not a concern because an estate is below the exemption level, it is important to have a proper estate plan to ensure that the needs of intended beneficiaries are met. Please schedule an appointment with us to discuss how you and your family can make the best use of the new estate and gift tax rules.

Sincerely,

Rotroff, Fisher & Co., P.A.

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