

New estate tax uncertainties

Advent of a kinder, gentler estate tax.

The December bipartisan compromise over extending the “Bush tax cuts” included somewhat controversial taxpayer-friendly changes to the federal estate tax. The amount exempt from this levy was set at \$5 million. It had been \$3.5 million in 2009 and would have gone to just \$1 million in 2011, absent the compromise. In addition, the top estate tax rate was set at 35%, down from the 45% rate in 2009 and far less than the scheduled 55%. The 5% surtax on estates over \$10 million was not renewed.

For many taxpayers, these changes could mean that softening the impact of the federal estate tax is no longer a significant factor in estate planning, especially when coupled with the new “portability” rule for married couples. In fact, it’s been estimated that there will be fewer than 3,000 federally taxable estates in each of the next two years.

On the other hand, what happens in 2013? The debate over lifting the exempt amount was contentious, and deficits are not projected to be lower in two years. As the law stands today, we will return to the \$1 million exemption and 55% top estate tax rate after 2012 unless Congress acts. Estate planning needs to be done with a longer time horizon than that.

Resolution for 2010 decedents

The \$5 million estate tax exclusion was made retroactive to the beginning of 2010, when the estate tax expired. Those who were hoping to dodge the death tax still may do so. Executors for estates of 2010 decedents have nine months after the enactment of the 2010 Tax Act to elect out of the estate tax, choosing the carryover basis regime instead. Under that approach, inherited assets do not get an automatic basis step-up at death, so heirs could be exposed to hefty taxes on capital gains. The executor is authorized to make \$1.3 million worth of basis adjustments.

The estates of the billionaires who died in 2010 are almost certain to opt out of the estate tax. Those with estates of \$5 million or less certainly will prefer to opt in, to get the basis step-up. Estates in the \$5 million to \$20 million range have some number crunching to do.

Example. Mary, a single person, had a \$15 million estate. Had she died in 2009, her estate would have owed \$5,175,000 in federal estate taxes. But because she died in 2010, the potential estate tax will be only \$3,500,000.

Let’s say that Mary’s tax basis in all her property comes to \$8.7 million. Her executor adds \$1.3 million, bringing it to a total of \$10 million. If she opts out of the estate tax, her heirs will owe tax on capital gains of \$5 million when they sell the assets. Still, at 15% that comes to just \$750,000, so Mary’s estate would prefer to opt out of the estate tax.

Now assume that Mary has a zero basis; her heirs get the benefit of only the \$1.3 million elective step-ups. The heirs’ potential capital gain tax, assuming application of the 15% tax rate in force for the next two years, comes to \$2,055,000. That’s still a better number than the estate tax, and it doesn’t have to be paid within nine months of Mary’s death.

Gift and generation-skipping transfer taxes.

The amount exempt from federal gift tax was \$1 million in 2010. That figure jumps to \$5 million for gifts in 2011. The exemption from the generation-skipping transfer tax goes to \$5 million as well. These exemptions are tied to the estate tax exemption, and they will be adjusted for inflation beginning in 2012.

Just as with the estate tax, these higher exemptions expire at the end of 2012. After that, current law provides for a top gift tax rate of 55%. That fact, coupled with depressed asset prices, has many estate planners suggesting that their clients consider carefully the advantages of an aggressive program of gifting in the next two years, restructuring family wealth on a tax-advantaged basis.

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