

## Law

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By Robert Goff

### **Law brings major changes to estate, gift taxes**

On Friday, Dec. 17, President Barack Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, making major changes to the estate tax and gift tax.

Most people are aware that the estate tax was repealed for 2010. Most people are also aware that the estate tax was scheduled to return with an exemption of \$1 million per spouse on Jan. 1, 2011.

The anticipated return of the estate tax in 2011 with an exemption or credit of only \$1 million per spouse (compared to an exemption of \$3.5 million in 2009) caused great anxiety for many business owners. Recent legislation eliminates most anxiety by increasing the estate and gift tax exemptions to \$5 million, at least for two years.

#### **\$5 million estate tax exemption amount**

For decedents dying in 2010, 2011 and 2012, the applicable estate tax exemption or credit is \$5 million with a maximum estate tax rate of 35 percent (compared to a previously scheduled maximum rate of 55 percent for 2011). Thus, an individual can leave up to \$5 million tax free to his heirs without incurring any federal estate tax liability — assuming he hasn't used any of his gift tax lifetime exemption. This is a significant increase from the \$1 million exemption scheduled to take effect in 2011 under prior law, and the \$3.5 million exemption in effect in 2009. Absent additional congressional action, the recent changes are scheduled to expire on Dec. 31, 2012, returning the estate tax exemption to \$1 million with a maximum rate of 55 percent.

#### **Exemption planning for married couples**

Married couples have an advantage over single individuals in that each spouse possesses a \$5 million exemption for a total exemption of \$10 million per couple. Furthermore, there is an unlimited exemption for all property that a deceased spouse leaves to the surviving spouse. Thus, spouses with a potentially taxable estate usually focus their estate plan on utilizing the maximum amount of the first-to-die spouse's exemption and passing the remainder to the surviving spouse. This

is usually accomplished by placing a credit shelter trust in the couple's estate planning documents.

The credit shelter trust is generally funded with the deceased spouse's exemption, the maximum amount of property that a deceased spouse may leave to his or her children without any estate tax liability. All the income from the credit shelter trust is paid to the surviving spouse as is principal for the surviving spouse's health, support and maintenance. Upon the surviving spouse's death, the property in the credit shelter trust passes to the couple's beneficiaries without any estate tax liability.

If the deceased spouse owns property in excess of the then applicable exemption, such property often passes outright to the surviving spouse. Alternatively, such property can be placed in a trust for the surviving spouse called a qualified terminable interest property (Q-tip) trust designed to qualify for the unlimited exemption for property passing to the surviving spouse. All the income from the Q-tip trust is paid to the surviving spouse as is principal for the surviving spouse's health, support and maintenance.

As a result of the deceased spouse's exemption and the unlimited exemption for property passing to the surviving spouse, no estate tax is generally owed upon the death of the first spouse. Upon her death, the surviving spouse can use her exemption to shelter another \$5 million of the couple's remaining property from estate taxes upon her death.

### **Portability of the exemption**

Under prior law, if the first spouse to die failed to include a credit shelter trust in his or her estate planning documents, and instead left all his or her property to the surviving spouse, the exemption belonging to the first spouse to die would be forever lost.

Thus, instead of each spouse sheltering \$5 million from the estate tax for a combined exemption of \$10 million, the couple would only make use of the surviving spouse's \$5 million exemption, possibly losing substantial estate tax savings.

Recent legislation has, however, added a new concept called "portability" to estate tax law for first to die spouses passing away after Jan. 1, 2011. Under new law, if the first spouse to die fails to utilize his credit by including credit shelter trust planning in his or her estate planning documents, the surviving spouse can still use his or her exemption and the exemption unused by the first spouse to die. Couples and their advisors should note that in order for the surviving spouse to utilize the unused exemption belonging to the first spouse to die, the personal representative of the first spouse's estate must make an election following the death of the first spouse to die.

Before couples rush to their estate planning attorneys to remove credit shelter trust planning from their estate planning documents, they should note that — unless

Congress takes further action — the recent legislation expires on Dec. 31, 2012, and we return to the law in effect in 2001, meaning no portability and an exemption of \$1 million.

### **2010 decedents**

Recent legislation provides that the 2011 estate tax law (but not gift tax law) is retroactive to Jan. 1, 2010. Thus, for those decedents dying in 2010, the estate tax is automatically reinstated with an exemption of \$5 million and a maximum estate tax rate of 35 percent.

Furthermore, there is a step up in tax basis of a 2010 decedent's property to date of death values.

If a 2010 decedent's estate would be more favorably treated under prior law, his personal representative can elect to have his or her estate treated as if the estate tax was not applicable (still repealed). Favorable treatment under prior law is generally only likely in estates larger than \$5 million.

If a 2010 decedent's personal representative elects treatment under prior law, his or her heirs will not receive a tax basis in his assets equal to the date of death value. Instead, they will receive a tax basis equal to the decedent's tax basis. If the decedent owned the property for more than a short period of time, his or her tax basis is likely low. When the decedent's heirs eventually sell the inherited property they may be facing substantial income tax. Thus, in all but a few estates, no election into treatment under prior law should be made.

### **\$5 million gift tax exemption**

Most people are aware that there is also a federal tax on gifts made during an individual's lifetime, subject to the annual exclusion and a lifetime exemption. Unlike the estate tax, the gift tax was never repealed for 2010. For 2010, the gift tax lifetime exemption is \$1 million with a maximum rate of 45 percent. For gifts from Jan. 1, 2011, to Dec. 31, 2012, the gift tax lifetime exemption is \$5 million with a maximum gift tax rate of 35 percent. Use of an individual's gift tax lifetime exemption reduces his or her estate tax exemption dollar for dollar.

The gift tax annual exclusion is \$13,000 for 2010 and 2011. Thus, an individual can give \$13,000 annually per donee without using any of his gift tax lifetime exemption. Spouses can split such gifts for a total of \$26,000 per donee but must file a gift tax return to do so.

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