Big Picture of New Estate Tax Law

Heather A. Kmetz

The definition of "wealthy" is a moving target – especially over the last decade.

Under the recently enacted Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Act"), "wealthy" amounts to having a net worth in excess of $5 million dollars at death, which excess will be subject to a federal estate tax of up to 35 percent. In these times Congress isn't too certain of anything – let alone the definition of wealth – so the 2010 Act is only good through 2012. Then we'll have to see what replaces it.

Of course, the 2010 Act is itself a replacement for what was considered, by most measures, a relatively unpalatable set of laws that was scheduled to come into effect starting January 1, 2011. Further, the 2010 Act provides a great deal of opportunity for tax-advantaged wealth transfer and introduces a new concept that may enhance creditor protection planning.

EGTRRA, JGTRRA and the Great Recession (2001 – 2010). In the context of a growing economy fueled by consumer confidence in ever-climbing residential real estate values and Wall Street's corresponding mortgage-backed securities, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). This law as soon after amended by the Jobs and Growth Tax Relief Reconcilation Act of 2003 ("JGTRRA") and collectively has been referred to as the "Bush-era tax cuts". Perhaps in response to the sense that the federal estate tax had not kept pace and that "middle class" estates were increasingly subject to the tax (often based on the immense growth of value in the family home), the Bush-era tax cuts scheduled increases to the amount exempt from federal estate tax at death from $675,000 in 2001 to $3.5 million in 2009, and steadily decreased the maximum rate of tax imposed on estates from 55 % to 35 % in that same time.

However, the Bush-era tax cuts sought to do more than merely increase the exemption amount and decrease the rate of tax. Under EGTRRA/JGTRRA, the federal estate tax was to be wholly eliminated in 2010 and then restored in 2011 to a $1 million exemption amount and a maximum tax rate of 55 percent.

Most tax professionals believed that Congress would address this aberration in advance of the scheduled 2010 death of the death tax and its equally unsatisfying 2011 return. However, the economy took center stage as the nation was gripped by the Great Recession and Congress had little time to tinker with the federal estate tax law. So, the Bush-era tax cuts marched on through 2010.

The 2010 Act (2011 – 2012). On December 16, 2010, Congress passed the 2010 Act, which was signed into law by President Barack Obama the next day. It is a set of temporary tax policies negotiated between Congressional Republicans and the White

House, designed to stimulate a tentative economic recovery, encourage business growth and sustained employment, and satisfy campaign promises.

Unified Gift and Estate Tax. Under the 2010 Act, the federal estate tax exemption was raised to $5 million and the maximum estate tax rate is limited to 35 percent. But that is only helpful if you have the bad fortune of dying in 2011 or 2012. More meaningful from a wealth transfer planning perspective was the reunification of the federal gift and estate tax credit. Since 2002, the lifetime gift tax exclusion amount was limited to $1 million; it is now $5 million.

Understandably, individuals did not want to pay tax on lifetime transfers (gifts) that would transfer free of tax if held until death (since the estate tax exemption was higher than the gift tax exemption). However, this retention of wealth increases their potential federal estate tax liability due to the included appreciation and perhaps delays a younger generation's opportunity to put that wealth into more productive use through innovation and investment. Under the 2010 Tax, individuals now can gift up to $5 million – $10 million for married couples – free of gift tax. In addition, lifetime gift transfers totaling more than this amount in 2011 and 2012 will be subject to a federal gift tax of no more than 35 percent.

Although many are still trying to recover losses of the Great Recession and still others are simply unwilling to make substantial gifts for fear that they will not have sufficient wealth retained for themselves, what to do with this "additional" $4 million gift amount is an interesting discussion for those able and willing to entertain it. Persistently low interest rates and low valuations of closely-held businesses demand that relatively well-heeled business owners consider wealth transfer tax strategies that may have a short window of opportunity.

Unused Credit Available to Surviving Spouse ("Portability"). The 2010 Act introduces "portability" of the newly reunified gift and estate tax exemption amount into the law. Any unused amount attributable to someone who dies in 2011 or 2012 can now be used by the surviving spouse. If the deceased left all assets to a surviving spouse and did not have any planning to preserve the exemption amount or died with an estate of less than $5 million, the surviving spouse could transfer during lifetime or at death their unused amount (up to $5 million) plus the surviving spouse's remaining amount (as calculated under applicable law in the year of transfer – up to $5 million in tax years 2011 and 2012).

Additionally, the portability provision may enhance creditor protection planning through this two-year period, as spouses who have intentionally maintained separate assets need not be concerned that the estate tax exemption amount of a "poorer" spouse would be lost if such spouse predeceased the "wealthier" spouse.

The portability provision is not automatic; an election must be made on a timely filed federal estate tax return for the deceased spouse, even if the deceased spouse's estate value does not otherwise necessitate filing of a federal estate tax return.

Stepped-up Basis or No Federal Estate Tax. Representatives of 2010 estates may choose between the EGTRRA/JGTRRA provisions (no federal estate tax and modified carry-over tax cost basis) and the 2010 Act provisions ($5 million federal estate tax exemption and stepped-up tax cost basis).

Hypothetically, for a person who died in 2010 who truly lived the American dream and netted $5 million out of nothing (zero basis) and died without a surviving spouse, their beneficiaries would walk away with $5 million cash under the 2010 Act (less any state inheritance tax). The $5 million estate would be excluded from federal estate tax and no federal income tax (capital gains tax) would be owed on the day-after-death sale of those assets.

Alternatively, electing EGTRRA/JGTRRA provisions for that same 2010 decedent's estate, the beneficiaries would end up with $4.445 million (less any state income tax) because they would be subject to federal income tax on the built-in gain as calculated under that law.

Of course, wealthier 2010 decedents with higher basis property would fair much better under the Bush-era tax cuts, so is important to analyze each decedent's circumstances to determine the best choice.