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RIA Special Study: Estate and Gift Tax Relief in the 2010 Tax Relief Act (12/30/2010)

Federal Taxes Weekly Alert,

RIA Special Study: Estate and Gift Tax Relief in the 2010 Tax Relief Act

On December 17, the President signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Relief Act, P.L. 111-132). The 2010 Tax Relief Act extends for two years the Bush-era tax cuts, retains for two years favorable tax rates for long-term capital gains and qualified dividends, provides significant estate and gift tax relief, and includes a two-year AMT "patch." It also contains new tax breaks, including 100% first-year writeoffs of qualifying property placed in service after Sept. 8, 2010 and before Jan. 1, 2012, and a payroll/self-employment tax cut of two percentage points for 2011 for employees and self-employed individuals. Plus it extends a host of expired and expiring tax breaks for businesses and individuals as well as a number of key disaster relief provisions.

This Special Study explains how the 2010 Tax Relief Act modifies the transfer tax rules for 2010, 2011, and 2012.

For a Special Study on how the 2010 Tax Relief Act's sunset relief provisions protect key individual tax breaks, see ¶ 26 .

For a Special Study on the economic stimulus changes in the 2010 Tax Relief Act, see ¶ 4 .

For a Special Study on business tax breaks retroactively reinstated and extended by the 2010 Tax Relief Act, see ¶ 27 .

For a Special Study on extended tax breaks for individuals in the 2010 Tax Relief Act, see ¶ 33 .

For a Special Study on extended energy-related tax breaks and disaster relief provisions in the 2010 Tax Relief Act, see ¶ 30 .

Overview of relief. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), there was no estate tax for decedents dying in 2010, but estate and other transfer taxes were scheduled to rise substantially for post-2010 transfers. The 2010 Tax Relief Act provides temporary relief. Among other changes, it reduces estate, gift and generation-skipping transfer taxes for 2011 and 2012 and continues other estate and gift tax relief provisions that were set to expire after 2010. 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 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, which explained below, are temporary—much harsher rules are slated to return after 2012.

Background on EGTRRA Transfer Tax Changes

An understanding of the EGTRRA provisions is crucial to understanding the Act's changes. EGTRRA repealed the estate tax and the generation-skipping transfer (GST) tax for estates of individuals dying in 2010. However, to comply with budgetary rules, EGTRRA contained a so-called "sunset rule" under which the pre-EGTRRA rules were to return after 2010.

Under pre-EGTRRA law, there was no gift tax and no estate tax on the first \$675,000 of combined transfers during life or at death for gifts made and individuals dying in 2001. These two taxes were tied together under a unified system having a top rate of 55%. However, there were differences between the gift tax and the estate tax. One difference potentially affected the income tax of donees (recipients) of gifts and heirs of estates. A donee generally gets the donor's basis (usually cost) for a gift. As a result of this carryover basis, if there is a gift of appreciated stock, for example, the donee will have a taxable gain if he sells at the gift value. Property acquired from a decedent, however, generally gets a basis equal to its value at his death. This means that, on a later sale by the heir, he won't have to pay income tax on the appreciation in the property that occurred while it was held by the decedent.

EGTRRA substantially increased the \$675,000 exemption in stages after 2001. For individuals dying in 2006 through 2008, the exemption was \$2 million. It rose to \$3.5 million for individuals dying in 2009.

EGTRRA also changed the unified system so that the gift tax exemption amount remained at \$1 million for all years after 2001. Under the "sunset rule," the exemption was to be \$1 million for both estate and gift tax purposes in 2011.

Under EGTRRA, the top estate and gift tax rate was reduced in stages. It was 45% for transfers in 2007 through 2009. In 2010, there was to be no estate tax and the top gift tax rate was to be 35%. The top estate and gift tax rate was to revert to 55% in 2011.

For 2010, the basis rules for inherited property were to be similar to the gift tax rules, but with many opportunities for heirs to get increases in basis. For example, these so-called modified carryover basis rules would have permitted the basis of assets received from an individual dying in 2010 to be increased by \$1.3 million and by an additional \$3 million for assets going to a spouse. Under the sunset rule, the pre-EGTRRA step-up in basis rules were to return for 2011.

EGTRRA made other changes to the transfer tax rules that also were scheduled to sunset after 2010. For example, it repealed the State death tax credit and replaced it with a deduction. Under the sunset rules, the deduction was to end and the credit was to return in 2011.

EGTRRA also repealed the qualified family-owned business deduction, which was to return in 2011. It also made modifications to the rules regarding (1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the GST tax. These modifications were to terminate under the sunset rule.

Increased Exemption and Reduced Top Rate


The 2010 Tax Relief Act lowers estate and GST taxes for 2011 and 2012 by increasing the exemption amount (technically, the applicable exclusion amount) from \$1 million to \$5 million (as indexed after 2011) and reducing the top rate from 55% to 35%. (Code Sec. 2010(c) , as amended by Act Sec. 302(a)) The \$5 million exemption is per person. Thus, there is a \$10 million exemption for a married couple. Plus, as explained below, there is a new portability feature for married couples.


Modified Carryover Basis Rules Generally Repealed


The 2010 Tax Relief Act generally repeals the modified carryover basis rules that, under EGTRRA, would apply only for purposes of determining basis in property acquired from a decedent who dies in 2010. Under the Act, a recipient of property acquired from a decedent who dies after Dec. 31, 2009 generally will receive fair market value (i.e., "stepped up") basis under the rules applicable to assets acquired from decedents who died in 2009. (Act Sec. 301) However, if an executor chooses no estate tax for a decedent dying in 2010, the modified carryover basis rules apply, as discussed below.


Special Choice for 2010 Decedents

The 2010 Tax Relief Act allows estates of decedents dying 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. (Act Sec. 301(c)) In technical terms, the Act achieves this choice by making the estate tax and basis changes effective retroactively for estates of decedents dying after 2009 (Act Sec. 301(a)), but allowing the opt-out choice for estates of decedents dying in 2010. (Act Sec. 301(c))

 RIA recommendation: The executor should make whichever choice would produce the lowest combined estate and income taxes for the estate and its beneficiaries, as shown in the following simplified illustrations.

 RIA illustration 1: Smith, a single individual, dies in 2010 with an estate worth \$6 million and with a basis of \$3.7 million. Under the Act, his heirs would face an estate tax of \$350,000 (\$2,080,800 tax on \$6 million under the new rate schedule reduced by \$1,730,800 tax offset by applicable exclusion amount), and they would get a step-up in basis. If the executor were to make the election, the estate would owe no estate tax and his heirs would face income tax on \$1 million worth of assets when they sell them. This is the \$6 million they inherit less a basis of \$5 million (Smith's original \$3.7 million basis as increased by \$1.3 million under the modified carryover basis rules). Assuming the \$1 million were taxed at 15%, the income tax cost would be \$150,000. Thus, the election should be made as it would result in lower combined estate and income tax (\$150,000 as opposed to \$350,000).

 RIA illustration 2: Assume the same facts as in the preceding example, except that Smith's basis immediately before death was \$700,000. If the executor were to make the election, there would be no estate tax but the beneficiaries would face income tax on \$4 million. At 15%, this would come to \$600,000. This would be more than the \$350,000 in estate tax that would be owed without the election. Thus, the election should not be made in this instance.

 RIA observation: The illustrations assume that the beneficiaries would sell the inherited assets reasonably soon after the decedent's death. Obviously, the results would be different if the beneficiaries planned to retain the assets or sell them several years down the road. Also, the results in any case would be impacted by state death taxes, if any, plus estate administration costs and other estate expenses. For the sake of simplicity, these factors were ignored in the foregoing illustrations.

The election will have no effect on the continued applicability of the GST tax. In addition, in applying the definition of transferor in Code Sec. 2652(a)(1), the determination of whether any property is subject to the estate tax is made without regard to whether an election is made.

IRS is to determine the time and manner for making the election. Once made, the election is revocable only with IRS consent. (Act. Sec. 301(b), Committee Report)

Gift Tax Changes

Under the 2010 Tax Relief Act, for gifts made in 2010, the exemption is \$1 million and the gift tax rate is 35%. For gifts made after Dec. 31, 2010, the gift tax is reunified with the estate tax, with an applicable exclusion amount of \$5 million and a top estate and gift tax rate of 35%. (Act 301(b), and Code Sec. 2505(a), as amended by Act Sec. 302(b))

The Act also makes clarifying changes to how gift taxes are taken into account in the mechanism for computing estate and gift taxes. Under pre-Act law, the gift tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after Dec. 31, '76, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after Dec. 31, '76 if the tax rate schedule in effect in the current year had been in effect on the date of the prior-year gifts. Under the Act, for purposes of determining the amount of gift tax that would have been paid on one or more prior year gifts, the estate tax rates in effect under Code Sec. 2001(c) at the time of the decedent's death are used to compute both (1) the gift tax imposed with respect to such gifts, and (2) the unified credit allowed against such gifts. (Code Sec. 2001(b)(2), as amended by, and Code Sec. 2001(g), as added by, Act Sec. 302(d))

Generation-Skipping Transfer Tax Changes

Under the 2010 Tax Relief Act, the GST exemption for decedents dying or gifts made after Dec. 31, 2009 and before Jan. 1, 2011 is equal to the applicable exclusion amount for estate tax purposes (e.g., \$5 million). Therefore, up to \$5 million in GST tax exemption may be allocated to a trust created or funded during 2010. Although the GST tax is applicable in 2010, the GST tax rate for transfers made during 2010 is 0%. (Act Sec. 302(c)) The GST tax exemption for decedents dying or gifts made after Dec. 31, 2010 is equal to the basic exclusion amount (a new concept arising under the portability feature, discussed below) for estate tax purposes (e.g., \$5 million, as indexed). (Code Sec. 2631(c), as amended by Act Sec. 303(b)(2)) The GST tax rate for transfers made in 2011 and 2012 is 35%. (Act Sec. 301, Act Sec. 302)

The Act extends the EGTRRA modifications to the rules regarding various technical aspects of the GST tax. (Act Secs. 101(a) and 301(a), Committee Report)

Portability of Unused Exemption between Spouses

Under the 2010 Tax Relief Act, any exemption that remains unused as of the death of a spouse who dies after Dec. 31, 2010 (the "deceased spousal unused exclusion amount") is generally available for use by the surviving spouse, as an addition to the surviving spouse's exemption. A surviving spouse may use the predeceased spousal carryover amount in addition to his or her own \$5 million exclusion for taxable transfers made during life or at death. (Code Sec. 2010(c), as amended by Act Sec. 303(a)) In technical terms, the Act achieves this result for decedents dying and gifts made after 2010 by defining the applicable exclusion amount as the basic exclusion amount (\$5 million for 2011, as indexed) plus the deceased spousal unused exclusion amount. (Code Sec. 2010(c)(2), as amended by Act Sec. 303(a))

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of \$5 million or the unused exclusion of the last such deceased spouse. (Code Sec. 2010(c)(4) , as amended by Act Sec. 303(a))

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise must file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, IRS may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. (Code Sec. 2010(c)(5) , as amended by Act Sec. 303(a))

Illustration : Husband 1 dies in 2011, having made taxable transfers of \$3 million and having no taxable estate. An election is made on his estate tax return to permit Wife to use his deceased spousal unused exclusion amount. As of his death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death. (Committee Report)

Illustration : Assume the same facts as in the prior illustration, except that Wife subsequently marries Husband 2. He predeceases Wife, having made \$4 million in taxable transfers and having no taxable estate. An election is made on his estate tax return to permit Wife to use his deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is \$3 million (\$2 million for Husband 1 and \$1 million for Husband 2), only Husband 2's \$1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount (\$5 million) or the unused exclusion of the last deceased spouse of the surviving spouse. Thereafter, Wife's applicable exclusion amount is \$6 million (her \$5 million basic exclusion amount plus \$1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death. (Committee Report)

Extension of Filing Deadlines

Under the 2010 Tax Relief Act, for a decedent dying after Dec. 31, 2009 and before Dec. 17, 2010, the due date for certain tax actions is not to be earlier than Sept. 17, 2011 (the date that's nine months after the Dec. 17, 2010 enactment date). This extension applies for:

- ... filing an estate tax return required under Code Sec. 6018 ;
- ... paying the estate tax; and
- ... making any Code Sec. 2518(b) disclaimer of an interest in property passing by reason of the death of such a decedent. (Act. Sec. 301(d)(1))

For a generation skipping transfer made after Dec. 31, 2009 and before Dec. 17, 2010, the due date for filing any return required under Code Sec. 2662 (including the making of any election required to be made on the return) is not to be earlier than Sept. 17, 2011 (the date that's nine months after the Dec. 17, 2010 enactment date). (Act. Sec. 301(d)(2))

Other EGTRRA Changes Temporarily Continued

The 2010 Tax Relief Act temporarily continues other changes made by EGTRRA for decedents dying after Dec. 31, 2009 and before Jan. 1, 2013, including the deduction for certain death taxes paid to any State or the District of Columbia and modifications to the rules regarding qualified conservation easements and installment payment of estate taxes. (Act. Sec. 101(a), Committee Report))

New EGTRRA Sunset

Under the 2010 Tax Relief Act, the sunset of the EGTRRA estate, gift, and GST tax provisions, which was scheduled to apply to the estates of decedents dying, gifts made, or generation-skipping transfers made after Dec. 31, 2010, is extended to apply to estates of decedents dying, gifts made, or generation skipping transfers made after Dec. 31, 2012. The EGTRRA sunset, as extended by the Act, applies to the amendments made by the Act. Therefore, neither the EGTRRA rules nor the new 2010 Tax Relief Act rules will apply to estates of decedents dying, gifts made, or generation-skipping transfers made after Dec. 31, 2012.