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Patent Pending

The Estate and Gift Tax Changes in the Recently Enacted 2010 Tax Relief Act

Lower rate and higher exemption for 2011 and 2012

For estates of decedents dying in 2009, there was a \$3.5 million exemption on the total property owned by the decedent(s) and the top tax rate was 45%. These rules expired at the end of 2009 and led to a one-year hiatus of estate tax for 2010. The exemption amount was scheduled to decrease significantly in 2011 to \$1 million and the top tax rate was supposed to increase to 55 percent. The 2010 Tax Relief Act provided temporary relief for 2011 and 2012 as the exclusion amount has been increased to \$5 million, the top tax rate set at 35 percent and the step-up in basis rules have been reinstated.

Special tax saving choice for 2010

Although the estate tax was repealed for 2010, the step-up in basis rules were replaced by the modified carryover basis rules. A basis measures income tax gain or loss when an asset is sold. With a step-up in basis, pre-death gain is eliminated because the basis carried onto the heir is increased to the date of death fair market value of the asset. On the other hand, with a modified carryover basis, a 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.

The 2010 Tax Relief Act amended the rules for 2010 allowing estates of decedents who died in 2010 to choose between paying an estate tax based on a \$5 million exemption, a 35% top rate and using the step-up in basis rules, or paying no estate tax and using the modified carryover basis rules. The differences between the step-up in basis and the modified carryover basis rules significantly 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 shared a single exemption and were subject to the same rates. In recent years, different exemptions and rates have been applied to gift and estate taxes. In 2010, the top gift tax rate was 35% and the exemption was \$1 million, while there was no estate tax in 2010. The gift tax rules have been modified for gifts made after Dec. 31, 2010, as the gift tax exemption was increased from \$1 million to \$5 million and the tax rate was left unchanged to realign the gift tax rules with the estate tax rules for 2011.

GST tax changes

The Generation Skipping Transfer tax is an additional tax on gifts and bequests given to grandchildren from their grandparents while the grandchild's parents are still alive. The 2010 Tax Relief Act lowers the GST tax rate for 2011 and 2012 from 55 percent to 35 percent and increases the exemption amount from \$1 million to \$5 million.

New portability feature

Under the prior law, the exemption from estate tax from 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 wealthier spouse. One way to address that issue was to set up a trust for the spouse with a smaller estate. The 2010 Tax Relief Act established the portability rule which may make setting up a trust unnecessary in some cases although, there still may be other reasons to employ credit shelter trusts. For example, a credit shelter trust may protect against the appreciation of assets 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 assets from creditors.


Under the 2010 Tax Relief Act, the portability rule was established which allows any exemption that remains unused after Dec. 31, 2010 and before Jan. 1, 2013 to be transferred to and 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. Any rollover exemption could potentially be lost, however, if the surviving spouse remarries and is again widowed.

The estate tax relief in the new law is substantial, but it is important to remember that these changes are temporary. The current revisions expire at the end of 2012, at which time all revisions revert back to the 2001 rules which were highly unfavorable. 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. Contact Brian McQuade today at bmcquade@mcquadebrennan.com.

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