MorrisonCohen LLP

CLIENT UPDATE

Highlights of New Estate and Gift Tax Legislation

The recent *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* establishes a new (but temporary) estate and gift tax structure for 2011 and 2012. It also addresses tax issues for estates of persons who died in 2010.

The summary below highlights the estate and gift tax provisions of the Act.

Tax Rates and Tax Exemption

For estates of persons who die in 2011 or 2012, the federal estate tax exemption is $5 million and the tax rate is 35 percent. In 2012, that $5 million exemption amount could be increased by an adjustment for inflation.

Reinstatement of the Step up in Basis for Inherited Assets

The new act reinstates the pre-2010 rule allowing the federal income tax basis of inherited assets (like real estate and stock) to be stepped up to reflect the fair market value as of the date of death. This replaces the rule for decedents who died in 2010, which provided instead for a modified carryover basis rule which limited basis increases, the amount of adjustment depending on whether the heirs were a spouse or non-spouse.

Estate and Gift Tax Exemptions Are Now Equal

For 2011 and 2012, the new law increases the lifetime federal gift tax exemption to $5 million (indexed for inflation at 2012). This means that the gift tax exemption is now equal to the estate tax exemption. Therefore, an individual can give away up to $5 million in total in 2011 and 2012 (a married couple could give away up to $10 million). Those gift exemptions are in addition to the $13,000 per recipient annual exclusion gifts already exempt from gift tax by the annual federal gift tax exclusion. The $5 million federal estate tax exemption would be reduced, to the extent gifts use up some of the $5 million federal gift tax exemption

The tax rate on gifts in excess of the $5 million exemption is the same 35% as the estate tax rate.

Any Unused Estate Tax Exemption of a Spouse Is Portable

Under the new law, unused federal estate tax exemptions of persons who die in 2011 or 2012 are "portable" – that is, they can be used for the estate of their surviving spouses. Some examples of how this could work are below.

Married Couples

Because of the portable estate tax exemption in conjunction with the unlimited marital deduction, the first spouse to die can bequeath his or her entire estate to the surviving spouse without federal estate tax (assuming the surviving spouse is a U.S. citizen).. The surviving spouse then has two $5 million exemptions, for a total of $10 million (assuming the surviving spouse dies in 2011 or 2012).

That means the surviving spouse can leave up to $10 million to his or her heirs (for example, the couple's children) without any federal estate tax (assuming the surviving spouse dies in 2011 or 2012).

The new portable estate tax exemption allows the first spouse to die to leave everything to the surviving spouse without losing the benefit of his or her $5 million federal estate tax exemption. Because the deceased spouse's unused exemption can be passed along to the surviving spouse, he or she effectively is given a $10 million federal estate tax shelter.

Example 1: A married man dies in 2011 leaves his entire $3.5 million estate to his wife. This results in no federal estate tax bill because of the marital deduction, and does not use any of his $5 million exemption. The executor of the husband's estate transfers the unused $5 million exemption to the surviving wife. If she dies in 2011 or 2012, her estate therefore has a $10 million exemption available (her own $5 million exemption in addition to the late husband's unused $5 million exemption). This means the wife can leave up to $10 million to the children without any federal estate tax bill.

Example 2: **A** married man dies in 2011 with a $3.5 million estate. He leaves all $3.5 million to his children (no Federal estate tax because his estate is under $5 million). The executor of his estate transfers the husband's $1.5 million unused exemption to the surviving wife. If the wife dies in 2011 or 2012, she could leave both her own $5 million exemption amount and her late husband's $1.5 million exemption (a total of $6.5 million) to the children without federal estate tax.

The New Law is in Place for Two Years

The new rules are in place for two years, and will be subject to review for 2013 and beyond.

Rules for Estates of Persons Dying in 2010.

The estate tax was technically reinstated for 2010 with a $5 million exemption and a 35 percent tax rate. Executors have the ability, however, to choose to elect out of the estate tax for 2010, in which case the modified carryover basis rules described above apply to heirs for income tax basis purposes. If an election out of the estate tax is not made, the $5 million exemption applies to the 2010 estate, and the income tax basis of inherited assets equals fair market value on the date of death—this result would be the usual choice for estates of $5 million or less. For estates in excess of $5 million, the executor can elect out of the estate tax, but the estate beneficiaries could later owe capital gain taxes on appreciated assets.

If you have questions concerning this report or other estate planning questions, please get in touch with your contact at Morrison Cohen or feel free to direct your questions to the head of our estate and trust department, William Haas, at (212) 735-8645 or bhaas@morrisoncohen.com.

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