

***Recent Changes in  
Federal Tax Laws  
Affecting Individuals,  
Businesses, and Estates***

**Part 4  
Changes Affecting Estates**

**Changes Affecting Estates**

For the first time in many years, there was no federal estate tax in 2010, but the tax was scheduled to return in 2011, with higher rates and lower exemptions than those in effect from 2002 through 2009. Now, the Tax Relief Act of 2010 (2010 TRA) has established more favorable estate tax provisions for decedents in 2011 and 2012 and given executors for estates created by deaths in 2010 a choice to make. The estate will be subject to the 2010 TRA provisions, unless they elect to stay with the old law. More on this later. First, the bill makes some significant modifications in the rules for estate taxes, gift taxes and generation-skipping transfer taxes.

With the 2010 TRA, the tax rates and exemptions for gifts (transfers made while living), estates (transfers made at death), and generation-skipping transfers (transfers to a beneficiary who is more than one generation younger than the person making the transfer) are again unified for 2011 and 2012. This means that, with a few exceptions, a single lifetime exemption is used for gifts and/or bequests and the tax rates are the same for these different types of transfers. This reunification is effective for gifts made after December 31, 2010.

**Exemptions.** Individual taxpayers are allowed an exemption (also called an “applicable exclusion amount”) that shelters an aggregate amount of lifetime gifts and transfers at death from estate and gift tax. If the total taxable estate and lifetime gifts are less than or equal to this amount, no federal estate tax will be due. For 2011 and 2012, the lifetime federal gift and estate tax exemption is \$5 million – with the 2012 exemption adjusted for inflation. This unified exemption also includes generation-skipping transfers.

The gift tax exemption for 2010, however, remains at \$1 million for 2010. The reunification with the \$5 million lifetime exemption is in effect for 2011 and 2012. For decedents dying or gifts made after December 31, 2009, the exemption for generation-skipping transfers will be \$5 million. The tax rate for generation-skipping transfers in 2010 is zero, but will be 35% for 2011 and 2012.

**Portability of unused exemptions.** The 2010 TRA allows the executor of a deceased spouse’s estate to transfer any unused exemption (limited to \$5 million) to the surviving spouse’s estate tax exemption (Table 6). This provision is effective for estates of decedents dying in the 2011 and 2012 tax years. This portability provision may allow married couples to pass up to \$10 million to their heirs free from estate taxes and is claimed by filing the estate tax return upon the death of the surviving spouse.

The example in Table 6 illustrates how the unused exemption from the estate of the first spouse to die can be transferred to the surviving spouse's estate resulting in a combined exemption of \$10 million and no estate tax liability. Like so many other aspects of the 2010 TRA, this provision is temporary and both spouses would have to die before the end of 2012 for it to apply.

**Table 6. Portability of Exemption Example**

	<b>First Spouse Dies</b>	<b>Surviving Spouse Dies</b>
Estate value	\$ 4 million	\$ 6 million
Exemption	\$-5 million	\$-5 million
Unused exemption	\$-1 million	
Transferred exemption		\$-1 million
Taxable estate	\$ 0	\$ 0

**Estate and Gift Tax rates.** The 2010 TRA sets the tax rate for the estate, gift, and generation skipping transfers to a flat-rate of 35 percent on the amounts above the exemption for 2011 and 2012. Table 7 compares the exemptions and rates over time under the prior law and with the 2010 TRA.

**Table 7. Estate-Tax Rates and Exemption Amounts**

	<b>Exemption Amount</b>	<b>Highest Rate</b>
<b>2009</b>	\$3.5 million	45%
<b>Prior Law: 2010</b>	100%	0%
<b>Prior Law: 2011-2012</b>	\$1 million	55%
<b>New Law: 2010*</b>	\$5 million	35%
<b>New Law: 2011-2012</b>	\$5 million**	35%
<b>2013</b>	\$1 million	55%

*\* Unless special opt-out election is made*

*\*\* Subject to inflation adjustment for 2012*

For 2011 and 2012, the gift tax exemption is unified with the \$5 million estate tax exemption and a gift tax rate of 35 percent. The annual exclusion for gift tax purposes will remain unchanged at \$13,000 for individuals. For gifts made in 2010, the gift tax rate is 35%; however, the exemption for gift tax purposes remains at \$1 million.

Generation-skipping transfers (GSTs) involve outright gifts or transfers through trust agreements from the grantor to the grantor's grandchildren, not the grantor's children. By skipping a generation, the grantor's children avoid estate taxes that would apply if the assets were transferred to them.

With the 2010 TRA unification, the \$5 million exemption and tax rate of 35 percent apply for GSTs in 2011 and 2012 with the 2012 exemption adjusted for inflation. For 2010, the \$5 million GST exemption is available regardless of the executor's election for 2010 estates. Transfers made in 2010, however, will be subject to a zero GST tax rate. Thus, gifts to grandchildren made in 2010 will incur no current GST tax. In addition, future distributions to the grandchild from such a trust created in 2010 can also be made free of the GST tax.

**Modified Carryover Basis versus Stepped Up Basis.** The Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA) completely repealed the estate tax for the 2010 tax year and replaced it with what is referred to as the **modified carryover basis** rules. So instead of the estates resulting from deaths in 2010 being subject to estate taxes, the heirs would be subject to higher capital gains taxes as a result of the carryover basis.

Prior to 2010, property passing through an estate received a **stepped up basis**. Under this rule, the cost basis of the property inherited by the heirs is the fair market value of the property on the date of death. With the stepped up basis, the heirs can sell the property with the likelihood of little or no capital gains tax.

With the carryover basis, however, the cost basis of the property passing to the heirs is the same as the decedent's basis.<sup>16</sup> For example, if Frank inherited property from his father, for which his father paid \$29,000 in 1946, Frank's basis would be \$29,000 even though the current market value might be over \$1,000,000. Obviously, this represents a potentially large capital gain for the heir, which would be subject to income tax upon sale of the property. In many cases, the historical records are not available to determine the carryover basis, resulting in a default basis value of zero.

For 2010 estates, the carryover basis of the decedent is modified for the heir. The executor is allowed to increase basis by \$1.3 million. If the estate is going to the spouse, the basis can be increased by an additional \$3 million for a total of \$4.3 million. However, the amount of the basis cannot be increased above the fair market value of the property.

The 2010 TRA generally repeals the modified carryover basis rules that were in effect for property inherited from a decedent who died in 2010 and reinstates the stepped up basis rules for estates in 2011 and 2012 and as an option for 2010. This means that property inherited from a decedent will receive a stepped-up basis (fair market value at date-of-death) under the rules applicable to 2009 estates. In the case of the estate created as a result of death in 2010, this will depend on the executor's decision as discussed in the next section.

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<sup>16</sup> More precisely, the carryover basis is the lesser of the fair market value of the decedent's property on the date of death or the decedent's original income tax basis in the property plus the value of certain improvements.

**Special provisions for deaths in 2010.** The 2010 TRA estate tax provisions are retroactive to January 1, 2010, reinstating the estate tax with the \$5 million exemption and 35% estate tax rate. The Act, however, allows an election (revocable only with IRS approval) to choose no estate tax and modified carryover basis for estates created by deaths in 2010. The executors of estates of individuals who died in 2010 have two options:

1. Take advantage of the \$5 million exemption, 35% rate, and stepped up basis for income tax purposes, or
2. Use the old 2010 rules with no estate tax and apply the modified carryover basis to calculate income taxes when the inherited property is sold.

For the executor of a large estate with several heirs, this is a complex decision depending on the type of property going to each heir, if or when the heirs plan to sell their inherited properties, and the projected capital gains upon sale. What is best for one heir may not be best for the others. This election is the executor's decision, and although it would be best if all heirs concurred in the decision, this may not always be possible.

The law also provides the heirs of decedents, who die in 2010 before the enactment of the new legislation, a nine-month extension for filing estate and gift/generation-skipping transfer tax returns and paying taxes. Specifically, in the case of a decedent dying after December 31, 2009, and before December 31, 2010, the deadline is extended to September 30, 2011.