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MEMORANDUM

FEDERAL ESTATE TAX UPDATE FOR 2011 AND 2012

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With the passage of the Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"), we have temporary estate tax relief for years 2011 and 2012. The Act also extends certain charitable contribution deductions that were set to expire at the end of 2010. Below is a discussion of the temporary estate tax changes and one of the more relevant extended charitable contribution deductions.

Estate Tax Changes

- For years 2011 and 2012, the federal *estate tax* and *gift tax exemption amounts* are now both \$5 million per individual (\$10 million for married couples). The highest estate and gift tax rate is 35%, down from 45% and 55%. In year 2010, there was no estate tax, and in year 2009, the estate tax exemption amount was \$3.5 million and the gift tax exemption amount was \$1 million. Without permanent relief, the estate and gift tax exemption amounts will revert to \$1 million in 2013.
- The *annual gift tax exclusion amount* for 2011 is still \$13,000 per donee (\$26,000 for married couples).
- The full "*stepped-up basis*" rule that existed in prior years (except 2010) applies again. Under this rule, if a donee inherits an asset at a donor's death, the donee's basis equals the fair market value of the asset at the donor's death. If instead a donor gifts an asset during his life, the donee takes the donor's cost basis in the asset. This is referred to as the "*carry-over basis*" rule. For example, if a donor during his lifetime gifts stock that he purchased for \$50 and is worth \$200, the donee's basis is \$50 and the donee would pay a capital gain tax if he sells the stock when it is worth more than \$50. If the donee received it at death and then immediately sold it, the donee would pay not capital gain tax.
- The *generation-skipping transfer (GST) tax¹ exemption amount* also increased to \$5 million for 2011 and 2012 and the GST tax rate is a flat 35%.

¹ The GST tax is a separate tax that taxes transfers that skip a generation, e.g., gifts from grandparents to grandchildren.

- New to the estate tax regime is a “*spousal portability*” provision. Under this provision, a surviving spouse can use her deceased spouse’s unused exemption. For example, if a spouse dies using only \$500,000 of his exemption amount, the surviving spouse can use the deceased spouse’s remaining \$4.5 million exemption amount. Until the portability provision is made permanent, this benefit is available only if both spouses pass away in 2011 or 2012 or one passes away in those years and the surviving spouse makes gifts over \$5 million in 2011 or 2012.

- The Act included relief for estates of *decedents who passed away in 2010*. For those estates, the new \$5 million estate tax exemption applies unless the executor elects the prior 2010 rule of no estate tax and a modified stepped-up basis rule. Most executors will chose the new law and have no filing obligation. If an executor wishes to use the prior 2010 rule, the executor must file an estate tax return. In either case, the executor still must obtain appraisals and date of death valuations to notify beneficiaries of their stepped-up bases in their inherited assets.

- The Act also clarified that the GST tax did apply in 2010 but the rate was 0%, ending concerns over charitable remainder trusts created in 2010 or other GST transfers in trust made in that year.

Charitable Contribution Deduction

- The Act also restores the IRA Charitable Rollover through the end of 2011. An IRA owner who is at least 70 ½ years old may “rollover” up to \$100,000 per year from an IRA to a public charity (although not a donor advised fund or a supporting organization). The donor need not take the distribution as “income,” and the rollover can count as part or all of the required IRA minimum distribution.

Planning Opportunities in 2011 and 2012

Unless Congress passes further temporary or permanent relief, single individuals with estates over \$1 million (or married couples with estates over \$2 million) **and** who can afford to give away assets without jeopardizing their financial independence or long-term care planning should consider gifting now, either outright or in trust, in case the exemptions amounts return to \$1 million. Parents who had put off transferring the family business to one or more of their children or making equalization gifts to non-owner children may wish to do so now. There are a multitude of factors to consider in making such gifts including (i) whether the donors will pay a clawback tax if the future estate tax laws do not recognize the 2011 and 2012 higher exemption amounts, and (ii) whether the donees will take the donor’s cost basis as opposed to the fair market values at the donor’s death.

Estate Planning

Although these changes are temporary (set to expire in 2013), many practitioners expect permanent legislation before the end of 2012, with exemption amounts frozen at between \$3.5 to \$5 million. Because of the continued uncertainty of the estate tax, individuals and married couples should continue to do estate planning. Joint trusts may be appropriate for married

couples with less than \$1 million. Married couples with estates over \$1 million may consider disclaimer trust planning which allows a surviving spouse to disclaim assets to fund the credit shelter trust upon the first spouse's death if the estate tax laws revert to less favorable exemption amounts or if a couple has a "state" estate tax because of owning real estate outside of New Hampshire. While higher exemption amounts may eliminate the need for married couples to split assets and create "marital" and "credit shelter" trusts, known as "A" and "B" trusts, there are other purposes for such trusts -- protection of funds for minors or incapacitated individuals, probate avoidance, ease of administering your affairs if you become incapacitated, and protection of trust assets for children or surviving spouse against dissident spouses or creditor claims.

Married couples who currently have trusts or wills should review them to determine what happens upon the first spouse's death. Do the documents provide that the exemption amount (up to \$5 million) passes to the surviving spouse outright or does it pass into a trust for the benefit of the spouse and/or children or stepchildren? For couples in a long-term first marriage, passing outright to the surviving spouse may be fine and is simple, giving ultimate control to the surviving spouse. Couples in a second marriage or concerns about a surviving spouse disinheriting a child, marrying the ne're-do-well, having creditor exposure, or having spendthrift tendencies may wish to retain the credit shelter trust at the first spouse's death for the benefit of the surviving spouse but ensure its protection².

Conclusion

If you would like to meet with one of our estate planning attorneys to review your current plan in the light of these changes, you may contact us at 778-0686.

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² Credit shelter trusts and marital trusts do not protect against Medicaid.