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Board of Contributors: Now is the time to consider making gifts to the next generation

Sheri Schultz

The new estate tax act passed by Congress late last year seems straight forward. But there are new opportunities for people to plan so there's more money available for their heirs.



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Before Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, there was no estate tax for individuals who died in 2010. Because the act is retroactive to January 1, 2010, the tax for last year was reinstated and the exemption was increased to \$5 million. The act also imposed a flat 35 percent rate for estates over \$5 million and restored the a unlimited basis step-up rule for inherited assets. An "unlimited" or "full" step-up in basis means that an heir's basis in assets will be at fair market as of the date of the decedent's death or the alternate valuation date, if applicable, which is six months after the date of death, thereby eliminating capital gains taxes on appreciation occurring through either of those dates. However, personal representatives also have the option of opting out of the estate tax by electing a modified carryover basis, rather than an "unlimited" or "full" step-up in basis.

For those who died in 2010, their personal representatives must either subject the estate to the new estate tax rules or elect out of the estate tax and subject the estate to the new modified basis rules. There will be no estate tax due. But assets transferred at death will receive only a limited step-up in basis. Therefore, heirs will owe income tax on the appreciation on those assets above \$4.3 million for a spouse and \$1.3 million for all others.

Estates valued over \$5 million will likely pick the modified carryover basis option. However, consideration must be given to the amount of potential estate tax as compared to the amount of potential capital gains tax. For most estates valued under \$5 million, the personal representative won't elect out of the estate tax system since there will be no estate tax due. The heirs of those estates will receive a fully stepped-up basis.

Determining whether to elect out of the estate tax will depend on many factors that require professional guidance. Additionally, it may be very difficult to obtain records from the acquisition of property which can make it nearly impossible to support asset basis. The step-up in basis alleviates the need to substantiate the basis of assets acquired years ago.

The act also increased the lifetime federal gift tax exemption for 2011 and 2012 to \$5 million, with the 2012 amount indexed for inflation. Thus, the gift and estate tax exemptions are equalized for 2011 and 2012. This is a great enhancement over the prior years \$1 million gift tax exemption. The exemption was not retroactive for 2010 and consequently, the gift tax exemption remains at \$1 million for 2010. Additionally, the gift tax exclusion reverts back to \$1 million after 2012.

Because of the increased gift tax exclusion, as well the current low values in the stock market, it is a good time for owners of closely held businesses to consider gifting shares of their business, creating family limited partnerships to hold securities and gifting interests in these entities. Recently, there have been bills floating around Congress that potentially eliminate minority interest discounts in business valuations. There is always the possibility that future changes to the law could be retroactive.

Transferring exemptions

The act also offers "portability" of the federal estate tax exemption between married couples, allowing married couples to pass \$10 million to their heirs, without incurring an estate tax. Portability is not retroactive to 2010 and is only applicable for individuals dying in 2011 and 2012.

Portability of the unused exemption amount may be an easy way to avoid estate taxes, but it may open the estate to family bickering and litigious creditors.

If Congress does nothing to extend the two-year window, then effective January 1, 2013, the estate tax exemption will decrease to \$1 million and the tax rate will be 55 percent.

Due to the changes and uncertainty of future legislation, now is the time to seek advice from a tax attorney and CPA.

If the estate plan bequests are based on a formula tied to the estate tax exemption at death, there could be unintended consequences resulting from the application of the formula to a higher estate tax exemption. For example, consider an estate valued at less than \$5 million. If a formula was based on giving a child an amount equal to the then current estate tax exemption, with the balance to the surviving spouse, the decedent may effectively disinherit the surviving spouse because of the new \$5 million exemption. The child now gets the entire estate which is less than \$5 million. The spouse gets nothing.

Now is the time to consider making gifts to the next generation.

First, the new exemption is \$5 million, which may decrease in 2013. This may be a unique opportunity.

Secondly, the act did not discuss discounts, which is an estate planning method of reducing your estate when gifting property. However, individuals should be aware of a potential "clawback" in future legislation.

Some experts speculate that if an individual uses the full \$5 million exemption, but dies during a year when the exemption amount is lower, there is a possibility that the then lower rate will be applied, imposing an estate tax on gifts previously thought to be tax free.

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