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After the Sun Sets:

A Brief Overview Of Estate Planning in 2011

Although we may find ourselves looking ahead to the start of a new year, let's take a moment to remember where we were at the start of this year.

As the new year rang in on January 1, 2010, so did the final year of the estate tax provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), leaving us in the wholly unexpected position of not having an estate tax. How did we get here?

The provisions of EGTRRA gradually increased the estate tax exemption amount from $1 million in 2002 to the maximum exemption of $3.5 million in 2009. On January 1, 2010, EGTRRA repealed the estate tax for one year. At the end of 2010, EGTRRA is set to expire and "[a]ll provisions of, and amendments made by, [EGTRRA] shall not apply…to estates of decedents dying, gifts made, or generation skipping transfers made, after December 31, 2010." (EGTRRA Section 901.) Consequently, upon the sunset of EGTRRA, the estate tax laws in effect in 2001 (pre-EGTRRA) are set to return, effective January 1, 2011, making it as though EGTRRA never existed.

Most practitioners believed that we would never reach the full estate tax repeal of 2010. Instead, it was widely thought that Congress would pass a permanent estate tax bill that would replace the final years of EGTRRA.

Then January 1, 2010, rolled around and we switched from speculating about what Congress would do to prevent the estate tax repeal to wondering whether Congress would act at all. It seems entirely possible that January 1, 2011, will arrive and we will find ourselves subject to the estate tax laws of 2001.

Now the question is: ***What were the estate, gift and generation-skipping transfer (GST) tax laws of 2001?***

Both the estate and gift taxes include an exemption amount—the applicable credit—which is a tax credit that shelters a certain amount of property from the estate or gift tax. Prior to EGTRRA, this credit amount was unified for estate and gift tax purposes, meaning that only the unused credit amount remaining at death was available to shelter assets from the estate tax. EGTRRA created a larger applicable credit for estate tax purposes than there was for gift taxes, thereby breaking the unification between the estate and gift tax exemption amounts.

After EGTRRA sunsets on December 31, 2010, the applicable credit for estate and gift taxes once again will be reunified. This means that any applicable credit not used during life will be available for use at death to shelter assets from the estate tax. If the applicable credit amount is used completely during life, then the entire estate's assets will be subject to estate taxes. Starting January 1, 2011, the applicable credit amount will be enough to shelter $1 million from the gift and/or the estate tax.

In addition to reunifying the applicable credit for estate and gift taxes, the sunset of EGTRRA also reunifies the tax rates for the gift and estate tax. Both the gift and estate taxes are calculated using the rate tables set forth for the estate tax under IRC Section 2001(c), although during 2010 when there was no estate tax, the gift tax was calculated under IRC Section 2502(a)(2) with a maximum estate tax rate of 35 percent. Starting January 1, 2011, the maximum estate and gift tax rate will be 55 percent, and it will apply to estates and gifts of more than $3 million. There is also a 5 percent surcharge that applies to estates and gifts over $10 million, although that surcharge is capped at an average maximum tax rate of 55 percent.

Because the estate and gift tax credits and tax rates are reunified, individuals should once again begin considering the benefits of making lifetime gifts of their assets, rather than relying on a larger estate tax exemption amount to shelter their estate from taxes. During the estate tax exemption increases of EGTRRA and the general uncertainty about what estate tax we would ultimately have, individuals largely stopped making gifts of their assets, preferring to wait until death to transfer assets.

Overall, lifetime gifts offer tax breaks that are not available when the assets are passed at death. The most obvious tax break is that a gift during life transfers with it all appreciation in the asset from the date of the gift to the date of death, which means that any growth in the asset is transferred by the decedent tax-free.

In addition, taxes paid on gifts made more than three years before the date of death are not included in the estate tax calculation, further reducing the taxable estate. The total amount of post-1976 gifts made by the decedent is included in the taxable estate, but the overall estate tax payable on the combined estate assets and gifted assets is reduced by the amount of tax that would have been due on the adjusted taxable gifts made, using the current gift tax rate. This results in a potential lower transfer tax paid on the gifted assets if the gift tax rate paid is lower than the estate tax rate in effect at the date of death.

Although lifetime gifts can result in lower transfer taxes, they might not result in lower taxes overall, when the appreciation in the asset is included in the calculation. With the return to the estate tax system as it existed before EGTRRA comes the return of the step-up in basis provided under IRC Section 1014.

When a gift is made, the basis in the asset plus all gain built into that asset carries over from the hands of the donor to the hands of the donee. Under Section 1014, all assets included in the taxable estate get a basis step-up to the fair market value of the asset on the decedent's date of death, effectively eliminating all gains in the asset. Therefore, when calculating the benefits of making a lifetime gift under the pre-EGTRRA tax regime, it's important to include an analysis of potential capital gains to the donee in order to determine the entire transfer taxes that would be paid.

The return to a pre-EGTRRA tax regime will not only bring back higher tax brackets, lower exemption amounts and a return of the basis step-up at death, it will also revive the state estate tax credit.

Prior to EGTRRA, under IRC Section 2011, a decedent's estate would get a credit for state estate taxes paid, meaning that if estate taxes were paid to the state, the federal estate tax bill would be reduced to compensate for those taxes. In order to fully take advantage of this federal tax credit, most states set their estate tax to match the maximum federal tax credit, thereby ensuring that estates did not pay a higher overall tax. Due to the increase in the federal estate tax exemption amount, EGTRRA phased out the state estate tax credit, which meant that many states lost out on their share of federal estate taxes paid. With the return to pre-EGTRRA tax laws, those states that have not "decoupled" from the federal tax system to create their own estate tax system will once again be able to receive funds equal to the estate tax credit.

Unlike the estate and gift tax exemption amounts, EGTRRA unified the estate and GST tax exemption amounts by changing IRC Section 2631(c) to state that the GST exemption amount is equal to the estate tax exemption amount under Section 2010(c). With the end of EGTRRA, the GST tax exemption amount will return to $1 million.

The interesting thing about the GST exemption amount is that, unlike the estate or gift tax exemption amounts, it is indexed for inflation. This inflation adjustment is equal to $1 million multiplied by the increase of the previous year's consumer price index (CPI) over the CPI in 1997; this increases the GST exemption amount in multiples of $10,000. Under this formula, using the first half semi-annual average CPI for 2010, the GST tax exemption amount for 2011 will be approximately $1.35 million.

The disconnect between the estate and gift tax exemption amounts and the GST tax exemption amount might at first suggest that the $350,000 by which the GST exemption exceeds the estate and gift exemption would go unused, but this fails to take into account the annual exclusion. Under IRC Section 2503(b), the first $10,000 of gifts an individual makes each year to any recipient are not subject to a gift tax. This initial $10,000 annual exclusion amount has also been indexed for inflation, which means that currently the annual exclusion is $13,000. While these $13,000 gifts are exempt from the gift tax, if they are made to a trust, they could be subject to the GST tax. This means that the excess $350,000 GST tax exemption amount could quickly be used up sheltering annual gifts to a GST trust.

As of the writing of this article, there have been a vast number of bills introduced to both houses of Congress dealing with the estate tax. These bills run the gamut from complete repeal of the estate, gift, GST and income taxes to an estate tax exemption of $5 million with a maximum tax rate of 35 percent. Due to a complete lack of consensus on this issue and the impending close of the congressional year, it seems wise that in addition to keeping an eye on what Congress is doing regarding this tax issue, we spend a little time refreshing the pre-EGTRRA tax regime in case we wake up on January 1, 2011 and find ourselves to have been transported back in time to the tax world of January 1, 2001.