

# Pathways

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Special Issue on the  
New Federal Tax Law

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# NEW TRANSFER TAX LEGISLATION

In its lame duck session at the end of 2010, Congress surprised many in the estate planning community by passing tax legislation. Among other things, that legislation substantially changed the federal gift, estate and generation-skipping transfer tax (“Transfer Tax”) laws for 2010 through 2012. This special issue of *Pathways* provides an overview of the new law – the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Act”). For a primer on Transfer Taxes, see “Transfer Tax Basics” on the back panel of this newsletter.

## ***New Transfer Tax Rules***

The new rules under the 2010 Act can be summarized as follows:

- Maximum Transfer Tax rate (all three taxes): 35%.
- Maximum Transfer Tax exemption (all three taxes): \$5 million.
- Indexing of exemptions for inflation after 2012 if the tax law changes are extended.
- Portable gift and estate tax exemptions for spouses (with a proper election).
- Income tax basis adjustments at death (for most assets) to date of death fair market value.

The above changes are effective retroactively, as of January 1, 2010, with respect to *estate* and *generation-skipping* taxes, but they are only effective as of January 1, 2011, with respect to *gift* tax. For estates of decedents dying in 2010, the default rule is that the estate tax applies, subject to the \$5 million exemption. However, one can elect to be governed by the law that was in effect during 2010 prior to the passage of the new act, which provided that the estate tax was completely inapplicable but that estate assets would receive only a limited basis adjustment.<sup>1</sup>

## ***Possible Reversion to 2001 Law***

Unless Congress extends these changes, they will not apply to transfers (during lifetime or at death) made after

2012; instead, the law in effect in 2001 will apply. That law can be summarized as follows:

- Maximum Transfer Tax rate (all three taxes): 55%.
- Maximum Transfer Tax exemption (all three taxes): \$1 million.
- No indexing of exemptions for inflation.
- Spouses’ gift and estate tax exemptions are not portable.
- Income tax basis adjustments at death (for most assets) to date of death fair market value.

## ***Incentive to Make Gifts***

While the *estate* tax exemption amount gradually increased during the past decade to \$3.5 million, for 2009 decedents, and became, in effect, unlimited for 2010 decedents (prior to the 2010 Act), the lifetime *gift* tax exemption remained where it stood in 2001 – at \$1 million. The 2010 Act finally increased the lifetime gift tax exemption from \$1 million to \$5 million for gifts made in 2011 or 2012. Thus, taxpayers who have already reached their \$1 million gift tax exemption limit under prior law may now make up to \$4 million in additional taxable gifts without having to pay gift tax.<sup>2</sup> Spouses who have already consumed their prior \$2 million combined gift tax exemptions can now make up to \$8 million in additional taxable gifts without having to pay any gift



The general information in this newsletter may or may not be appropriate for your particular situation. Before taking any action based on this newsletter, you should consult with your estate planning attorney.

tax. Taxpayers who make such additional gifts under the more generous 2011-2012 gift tax exemption will not be taxed on those gifts even if the 2010 Act sunsets and the less generous 2001 law again applies. This creates an incentive for taxpayers who can afford to do so to make larger gifts over the next two years.

### **Exemption Portability For Spouses**

If a married person's estate tax exemption is not fully used, the unused portion may now be used in the surviving spouse's estate. This spousal exemption "portability" (which requires an election) is a new concept and could simplify many estate plans if it

ultimately becomes a permanent feature of the law. Although portability will eliminate the need to segregate the deceased spouse's property in a separate trust<sup>3</sup> for *tax-planning* reasons, spousal trusts will continue to offer advantages unrelated to Transfer Tax planning and will therefore continue to be widely used.

### **Valuation Discounts**

The IRS has criticized (and often challenged) valuation discounts as applied to family

business interests. The 2010 Act did not change valuation standards or otherwise impact valuation discounts. For large estates, valuation discounts will continue to be important. But for most estates, the current interplay of high exemptions, income tax basis adjustments, and relatively close Transfer Tax and

income rates may now make valuation discounts less important or even undesirable.

### **Uncertainty Regarding Future Law**

The scheduled sunset of the 2010 Act at the end of 2012 continues the uncertainty that all of us have endured since the 2001 tax act, with its "sunset" provisions, first became law. Any one of several things could happen during the next two years: the 2010 Act could be extended (temporarily or permanently), the 2010 Act could be allowed to sunset two years from now in favor of the 2001 law, or the Transfer Taxes (which now affect very few estates and thus provide very little tax revenue) could be entirely repealed. This uncertainty makes planning more complicated for some. However, for many the new law creates at least a temporary opportunity.

### **Conclusion**

The 2010 Act surprised estate planners with its favorable new rules. For wealthier taxpayers, it creates an incentive to make additional gifts during the next two years. For most taxpayers, it will have little or no immediate impact and will not warrant a revision to their estate plans. Nevertheless, you may want to have your plan reviewed to be sure that it will function as you intend under the new law and that you are taking advantage of any new opportunities for Transfer Tax savings. Please contact your Downey Brand estate planner if you have questions.

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### **(Footnotes)**

<sup>1</sup> The 2010 law in effect prior to passage of the 2010 Act allowed estates to shelter up to \$1.3 million in capital gain and an additional \$3 million of gain on assets passing to (or in trust for the benefit of) a surviving spouse.

<sup>2</sup> Because the estate and gift tax systems are unified, use of one's lifetime gift tax exemption simultaneously consumes his or her estate tax exemption.

<sup>3</sup> Commonly referred to as a "Bypass Trust," a "Credit Shelter Trust," or, in the more distant past, as a "Trust B."



# Transfer Tax Basics

In considering the new law, an understanding of Transfer Tax basics is helpful. The Transfer Tax laws have generally had a consistent structure since 1976:

1. Gifts exceeding annual exclusions are taxable, subject to application of a lifetime gift tax exemption.
2. Assets in a decedent's taxable estate exceeding his or her available exemption amount are subject to estate tax (even if the assets are not subject to probate under local law).
3. Except for the period of 2004-2010, the estate and gift taxes are unified, with a single tax rate structure and combined exemption amount. (Taxable gifts reduce the amount of exemption available to shelter gifts made at death.)
4. Spouses may transfer unlimited amounts to each other (outright or in certain trusts) tax-deferred.
5. Certain generation-skipping transfers are subject to a separate, excise tax, with a maximum exemption amount equal to the maximum estate tax exemption.
6. Most assets in a decedent's estate receive a new income tax basis at death equal to the date of death fair market value of the assets.

In valuing property for Transfer Tax purposes, fractional interests in real estate (even 50% community property interests of spouses) and interests in non-public entities (e.g., family corporations, partnerships or limited liability companies) are valued at the price a real world buyer and seller would set as the value for the asset. This approach results in valuation discounts. For example, a spouse's 50% community property interest in a \$1 million apartment building might be worth \$400,000 rather than \$500,000.



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