BUTLER | SNOW
PLANNING NOTES
Vol. 2009 No. 4

Volume 2011 - January 27

The Tax Relief Act of 2010:
An Overview of Estate, Gift and Generation-Skipping Transfer Tax Provisions

Many articles have appeared recently in the press discussing the implications of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Act"). Most have focused on the extension of the Bush-era income tax cuts. This summary focuses on the estate, gift and generation-skipping transfer tax changes in the 2010 Act and associated planning opportunities.

Estate and Gift Taxes in 2011 and 2012

The federal estate tax exemption amount for the estates of individuals dying in 2011 and 2012 is set at $5 million as opposed to the $3.5 million exemption in 2009 or the $1 million exemption that would have applied in 2011 absent Congressional action. Additionally, the maximum estate tax rate for those estates is 35 percent tax as opposed to the 45 percent rate that applied in 2009 or the 55 percent rate that would have applied in 2011, absent Congressional action. The estate's assets generally take a basis equal to their fair market value on the date of the individual's death. On January 1, 2013, without further Congressional action, the exemption amount will revert back to $1 million, and the estate tax rate will increase to 55 percent.

In addition to the increase in the exemption amount and the decrease in the estate tax rate, Congress also granted spouses "portability" of their estate tax exemption amounts. This means that if the first spouse to die does not use all of his or her $5 million federal estate tax exemption, the remainder may be used by his or her spouse either during life or at death. This means that up to $10 million in assets may pass estate tax free to children or other beneficiaries. Portability applies only to the estates of individuals who die in 2011 and 2012 and not to those who die in 2010.

Prior to the 2010 Act, each person had a lifetime federal gift tax exemption of only $1 million. The 2010 Act increases each person's exemption amount to $5 million for gifts made in 2011 and 2012, and it sets the maximum gift tax rate on 2011 and 2012 gifts in excess of that amount at 35 percent.

Generation-Skipping Transfer Tax

Generally, the federal generation-skipping transfer ("GST") tax applies to transfers that "skip" a generation. For example, gifts to grandchildren or great-grandchildren are normally subject to the GST tax. In 2009, the federal GST tax exemption was $3.5 million, and the GST tax rate for transfers in excess of $3.5 million was 45 percent. However, the 2001 law repealed the GST tax for 2010. Because of this repeal, as with the estate tax, much uncertainty surrounded generation-skipping transfers made in 2010.

The 2010 Act eliminates that uncertainty by retroactively re-instating the GST tax and providing a zero percent GST tax rate effective for transfers made in 2010. This change protects generation-skipping transfers made in 2010 from GST tax and preserves the various GST tax exemptions that could reduce or eliminate the tax in future years.

In 2011 and 2012, the 2010 Act aligns the federal generation-skipping transfer tax with the federal estate and gift taxes by providing a $5 million GST tax exemption and a 35 percent rate applicable to taxable generation-skipping transfers in excess of the exemption amount. However, like the federal estate tax, without further Congressional action the federal GST tax will revert back to a $1 million exemption amount and a 55 percent rate for transfers made on or after January 1, 2013.

Please note that estate and gift taxes apply when an individual transfers assets with a value in excess of $5 million to anyone besides his or her spouse. The $5 million GST exemption does not permit additional transfers to pass free from estate and gift taxes, but merely allows $5 million of assets that would potentially be subject to both (1) the estate and gift tax regime, and (2) the GST tax regime, to escape the GST tax regime.

Estates of Individuals Dying in 2010

Though a 2001 law repealed the federal estate tax for individuals dying in 2010, most tax professionals believed that Congress would enact legislation prior to 2010 that would prevent the repeal. However, no such Congressional action came. As a result, much confusion and uncertainty surrounded the estates of individuals who died in 2010, as there was concern about Congress enacting legislation in 2010 or later that would be enforced retroactively to the estates of all individuals dying in 2010.

Under the 2001 law, no estate tax was to be imposed on the estates of persons dying in 2010, and beneficiaries of these estates were, generally, to take the same basis in inherited property that the individual had in that property (a "carryover basis"). As a result, when the beneficiary sold the carryover basis property, he or she would recognize gains or losses on the appreciation or depreciation inherent in the property when inherited. Each estate was, however, granted a total basis step-up allocation of $1.3 million to be allocated among assets transferred to anyone, and an additional $3 million step-up allocation for asset transfers to the surviving spouse either outright or in a qualifying trust.

The 2001 law provided that effective January 1, 2011, the federal estate exemption would revert to $1 million, the federal gift tax exemption would remain at $1 million and the top federal estate and gift tax rate would be 55 percent.

The 2010 Act provides that the federal estate tax will apply retroactively to the estates of all individuals dying in 2010. As noted above, the exemption amount for those estates is set at $5 million as opposed to the $3.5 million exemption in 2009 or the $1 million exemption that would have applied in 2011 absent Congressional action. Additionally, the maximum estate tax rate for those estates is now 35 percent. The estate's assets generally take a basis equal to their fair market value on the date of the individual's death. Importantly, the 2010 Act grants executors of the estates of individuals who died in 2010 the option of electing out of the newly enacted estate tax regime and into the carryover basis regime, discussed above.

The filing deadline for estate tax returns is generally nine months after the individual's date of death. However, the 2010 Act extends the deadline for filing estate tax returns for individuals dying in 2010 to nine months following the date of enactment of the 2010 Act, or September 19, 2011.

Planning Opportunities

All persons should carefully review their current estate plans to ensure that their exemption amounts are allocated in a manner consistent with their wishes. Many wills drafted in prior years utilize formula clauses, which leave, for example, an amount equal to the estate tax exemption in trust for the benefit of the individual's children and the remainder to their spouse. The increase in the estate tax exemption amount in the 2010 Act could result in the spouse inheriting much less than anticipated.

Persons with a high net worth should review their current estate plans and consider alternatives for taking full advantage of the $5 million estate tax exemption. Additionally, the 2010 Act provides high-net-worth persons who are willing to act in the next two years with the opportunity to gift up to $5 million (less any lifetime federal gift tax exemption previously used) free of federal gift tax and GST tax. For persons with family businesses, this presents an excellent opportunity, when combined with any available valuation discounts, to make large tax-free gifts of equity interests in the business for the benefit of children and future generations.

Finally, estate executors of individuals who died in 2010 must decide whether to subject the estate to the new estate tax regime (with a $5 million exemption and a 35 percent rate) or elect out of the estate tax regime and into the carryover basis regime. This decision will depend on the size of the estate, the beneficiaries of the estate and the appreciation inherent in the estate's assets.

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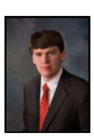

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