BRIAN M. MCDONALD
ATTORNEY AND COUNSELOR AT LAW
7755 Center Avenue, Suite 1100
Huntington Beach, California 92647
Telephone (714) 372-4955
Facsimile (714) 372-4958
brian.mcdonald.esq@gmail.com

February 2, 2011

ESTATE TAX 2010-12
A Space Odyssey

On December 17, 2010, President Obama signed the **Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act** (the "***Act***"). The Act extended the President Bush tax cuts for two more years and avoided what otherwise would have been the highest tax increase in American history. Significant for estate planners, the Act provides substantial, although only temporary, estate tax relief.

If not for the Act, the estate tax rate would have increased effective January 1, 2011 from 0% (2010 only) to **55%** and the "***estate tax exclusion***" (that portion of a decedent's estate that is exempt from estate tax) would have been set at $1,000,000. Instead, the Act sets the estate tax rate at **35%** and the estate tax exclusion at **$5,000,000**. In also increases the gift tax exclusion to $5,000,000. However, these rates and amounts are only effective for 2011 and 2012. Unless Congress acts, on January 1, 2013, the estate tax will increase to 55% and the estate tax and gift tax exclusions will reduce to $1,000,000.

It is important to note that the estate tax exclusion and the gift tax exclusion are unified. That is, there is only one exclusion. It may be applied to gifts made during a person's life time or to the person's estate or a combination of the two up to a maximum of $5,000,000. By way of example, assume John has an estate valued at $10,000,000. Assume John makes gifts during 2011 and 2012 totaling $2,000,000. John dies in 2012. His available estate tax exclusion would be $3,000,000 ($5,000,000 less the $2,000,000 in gifts).

The Act also allows the estate tax exclusion to be "portable" between a husband and wife. That means that on the death of the first spouse, that spouse's $5,000,000 can be "ported" to the surviving spouse giving the surviving spouse a $10,000,000 exclusion.

While the increase in the gift tax exclusion and the portability of the estate tax exclusion offers opportunities, unless Congress acts, they are largely illusory. They only work if both spouses die in 2011 or 2012. If not, the consequences can be disastrous.

EXAMPLE 1:

Husband and wife have an estate valued at $10,000,000 but have never put in place an estate plan. Husband dies in 2011. Because there is no estate tax on a husband to wife transfer, wife pays no estate tax and the husband's $5,000,000 exclusion is ported to the wife who now has a $10,000,000 exclusion. Unless the wife dies in either 2011 or 2012, in 2013 she loses the husband's $5,000,000

exclusion and her exclusion is reduced to $1,000,000 meaning $9,000,000 will be subject to a 55% estate tax rate resulting in the payment of an estate tax of $4,950,000.

If husband and wife had created an A-B-C or A-B trust, when the husband died, $5,000,000 could have passed through via a trust for the benefit of their children without any estate tax. When the wife later dies in 2013, her estate would only be $5,000,000. She would have the $1,000,000 exclusion meaning only $4,000,000 would be subject to estate tax resulting in a tax of $2,750,000, a savings of $2,200,000.

EXAMPLE 2:

Husband and wife have an estate valued at $8,000,000. Husband "gifts" $5,000,000 to their children in 2011, assuming that $3,000,000 was more than sufficient to support him and his wife for their remaining years. Because the gift is equal to the 2011 gift tax exclusion, there is no gift tax to be paid. Husband then dies in 2013. Because of the estate tax "look back", $4,000,000 of the gift is captured in the husband's estate and subject to an estate tax of 55%. That means $2,200,000 in estate tax. Because the $2,200,000 is being used to pay estate tax, it is not sheltered by the "marital exclusion" and it too is subject to a 55% estate ($1,210,000). Total estate tax is $3,410,000 meaning all of the $3,000,000 the husband was going to leave the surviving wife gets used for estate tax and the wife has to come up with an additional $410,000. The only thing that could make this worse is if the $3,000,000 was in an IRA (the withdrawal to pay estate tax would be subject to income tax).

Benjamin Franklin said the only two things certain in life are death and taxes. Under the new estate tax law, a well timed death has the potential for achieving a significant estate tax savings. However, I personally have never considered a premature death as a viable estate planning tool.

Since 1986, when a person inherited property, he or she got a "step up" (or in some cases a "step down") in the basis of the property. For capital gains purposes, the recipient's tax "basis" was the value of the property on the decedent's date of death. That meant that any appreciation in the property's value between when the decedent acquired the property and his or her date of death escaped capital gains taxation. For 2010, when the estate tax was eliminated for one year, the step up in basis was also eliminated (with a floating step up of $1.3 million of appreciated estate property with an extra $3 million available for the surviving spouse). The recipient's "basis" in inherited property was the same as that of the decedent. Unless the decedent kept meticulous books and records, just imagine the accounting nightmare trying to reconstruct the decedent's cost basis. Effective January 1, 2011 the prior step up rules are once again in effect. That provision is not scheduled to change in 2013.

Will Congress act? Well, all the pundits predicted with great authority that Congress would never allow the estate tax to expire in 2010. Shows how much they knew. So if those "in-the-know" couldn't get it right for 2010, there is no way I'm going to make a prediction for 2013. All I can say is stay tuned for the next edition of "**US Congress, A Space Odyssey**".

The Basic Estate Tax

The chart below represents the "basic" estate tax law; the underlying estate tax structure but for the several recent estate tax bills. The "estate tax exclusion" is expressed in thousands of dollars (add "000").

Year	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Exclusion	$675	$675	$750	$825	$900	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Tax	55%	55%	55%	55%	55%	55%	55%	55%	55%	55%	55%	55%	55%	55%

Economic Growth & Tax Relief Act of 2001

The chart below illustrated the modifications to the basic tax law imposed by President Bush's Economic Growth & Tax Relief Act of 2001 (the "EGTR"). Because Congress was unable to get the number of votes required to make a permanent change in the basic tax law, the EGTR sunset at the end of 2010 and the basic tax law came back into effect. Shaded areas are the changes imposed by the EGTR.

Year	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Exclusion	$675	$675	**$1,000**	**$1,000**	**$1,500**	**$1,500**	**$2,000**	**$2,000**	**$2,000**	**$3.500**	**None**	$1,000	$1,000	$1,000
Tax	55%	55%	**50%**	**49%**	**48%**	**47%**	**46%**	**45%**	**45%**	**45%**	**0%**	55%	55%	55%

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

The shaded areas in the chart below illustrates the changes imposed by the law signed by President Obama on December 17, 2010.

Year	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Exclusion	$675	$675	$1,000	$1,000	$1,500	$1,500	$2,000	$2,000	$2,000	$3.500	None	**$5,000**	**$5,000**	$1,000
Tax	55%	55%	50%	49%	48%	47%	46%	45%	45%	45%	0%	**35%**	**35%**	55%