¶ 3.04A The Economic Growth and Tax Reconciliation Act of 2001; the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010; and the American Taxpayer Relief Act of 2012

¶ 3.04A[1] In General

Prior to enactment of the Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA), the estate tax and the generation-skipping transfer (GST) exemption amounts were $1 million, and the top tax rate was 55 percent. EGTRRA gradually decreased the exemption amount and maximum exemption amount until they reached $3.5 million and 45 percent, respectively, in 2009. The gift tax exemption amount stayed at $1 million. The estate tax and GST tax were repealed in 2010 but returned in 2011 at their pre-EGTRRA levels ($1 million exemption and 55 percent maximum rate). The gift tax was left in place for 2010 to prevent taxpayers from shifting income to lower-bracket taxpayer rates, and it also returned in 2011 at pre-EGTRRA levels.

Although for most of 2010 it appeared that there would be no estate tax or GST exemption, Congress finally acted. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Act) [266.1] was signed into law by President Obama on December 17, 2010. The 2010 Act (1) created a maximum estate and gift tax rate of 35 percent and an exclusion amount of $5 million for 2011 and 2012; (2) permitted the executors of decedents dying in 2010 to choose between applying either the estate tax with the 2010–2012 rates and exemption amount or the Section 1022 modified carryover basis rules; and (3) provided for portability of the unused portion of a decedent's estate tax exemption amount to the surviving spouse. These provisions were set to expire in 2013, but the American Taxpayer Relief Act of 2012 (the 2012 Act), which was signed into law on January 2, 2013, repealed EGTRRA's sunset provisions and permanently adopted the changes made by the 2010 Act. Accordingly, the 2012 Act permanently set the estate, gift, and generation-skipping transfer tax exemption amounts at $5 million per taxpayer (to be indexed for inflation after 2011). While the 2012 Act retained the exemption levels for transfer taxes, it did increase the top estate and gift tax rates from 35 percent to 40 percent. These provisions raise interesting planning issues.

¶ 3.04A[1][a] Increased Exemption Amount

Assuming that the value of assets is increasing, making lifetime gifts enables a taxpayer to remove future appreciation from the estate, making lifetime gifts more tax efficient than transfers at death.

Example

Mark owns Blackacre, with a current fair market value of $4 million in 2013. Because he has made no previous taxable gifts, the full $5.25 million gift tax exemption for 2013 is available on the gift, and the property is expected to increase in value to $6 million by the time he dies. If Mark gifts Blackacre now, he will pay no tax, and it will be included in his estate as a $4 million adjusted taxable gift. If he dies with Blackacre, however, it will be included in his estate at its $6 million date-of-death value.

On the other hand, most taxpayers are averse to paying gift tax even if making gifts saves them taxes in the long run. Thus, they generally limit their lifetime gifts to the applicable exclusion amount available, or they make gifts to zeroed-out grantor-retained annuity trusts or charitable lead annuity trusts. In 2013 taxpayers will have an additional $5.25 million available for making lifetime gifts without current tax. This should greatly increase the popularity of making lifetime gifts for taxpayers with very large estates. A particularly favorable strategy may be to make lifetime gifts to intentional grantor irrevocable trusts, because taxpayers can transfer $5.25 million

of seed money to such trusts without paying any tax.

¶ 3.04A[1][b] Estate Tax/Modified Carryover Basis Election

Although a detailed explanation of the modified carryover basis system is beyond the scope of this treatise, a brief overview of the election decision available to estates of decedents dying in 2010 may be helpful. The decision involves a trade-off between paying estate tax and receiving a full basis step-up on all assets and paying no estate tax and receiving a maximum basis step-up of $4.3 million on transfers to the surviving spouse and $1.3 million on transfers to others.

Decedents who are single or a surviving spouse and have estates of less than $5 million are better off choosing to apply the estate tax, because it will give them a full basis step-up without paying any estate tax. For taxpayers with estates above $5 million, however, a quantitative analysis is necessary. A somewhat simplified model for doing this analysis would be simply to compare the sum of the estate tax and income tax paid, assuming that the heirs sold the property immediately after receiving it. The following example illustrates this analysis.

Example

Martha, a single taxpayer, dies in 2010 with an estate of $9 million. Her aggregate basis in the estate assets is $1 million. If her executor elects to have the estate tax apply, the tax payable will be as follows:

```
Estate tax          .35 × $4,000,000 = $1,400,000
Income tax          0
Total tax paid     $1,400,000
```

If her executor elects to have the modified carryover basis rules apply, the tax payable would look like this:

```
Estate tax         0
Income tax         .15 × ($9,000,000 – $2,300,000) = $1,005,000
Total tax paid     $1,005,000
```

Thus, Martha's executor should elect to have the modified carryover basis rules apply to the estate. Note that the break-even estate size for a decedent with $2,300,000 of basis would be $7,025,000. The total tax payable would $708,750 under either alternative, as shown below.

```
Estate tax         .35 × $2,025,000 = $708,750
Income tax         0
Total tax paid     $708,750
```

If Martha's executor elects to have the modified carryover basis rules apply, the tax payable would look like this:

```
Estate tax         0
Income tax         .15 × ($7,025,000 – $2,300,000) = $708,750
Total tax paid     $708,750
```

¶ 3.04A[1][c] Portability

Under the portability provision, after 2010 any exemption amount not used by the first spouse automatically would be available to the surviving spouse. Thus, for example, if the first spouse used only $3 million of his or her $5 million exemption amount, the remaining

$2 million would pass to the surviving spouse, providing that spouse with a $7 million exemption.

On the surface, it might appear that this would eliminate the need for bypass trusts, but this may not always be the case.

Example

H dies in 2011, and his entire estate of $2 million is placed in a bypass trust. *H*'s unused exemption amount of $3 million is available to his spouse, *W*. When *W* dies some years later, she has an estate of $8 million, and the assets in the bypass trust have doubled in value to $4 million. No tax is payable in *W*'s estate because she has a total exemption of $8 million ($5 million of her own plus $3 million from *H)*.

Now assume that instead of transferring the $2 million to a trust, *H* gives it outright to *W*. Because the marital deduction can be used to eliminate tax in *H*'s estate, his executor can allocate the full $5 million of exemption to *W*, giving her a total exemption of $10 million. Her estate is $12 million, however, so it pays an estate tax of $700,000.

266.1
Pub. L. No. 111-312.